CALL REPORT

INSTRUCTION BOOK UPDATE

SEPTEMBER 2010

FILING INSTRUCTIONS

NOTE: The pages listed in the column below headed “Remove Pages” are no longer needed in the *Instructions for Preparation of Consolidated Reports of Condition and Income* and should be removed and discarded. The pages listed in the column headed “Insert Pages” are included in this instruction book update and should be filed promptly in your instruction book.

Remove Pages	**Insert Pages**
iii – v (6-10)	iii – v (9-10)
RC-C-36a – RC-C-36b (3-10)	RC-C-36a – RC-C-36b (9-10)
RC-O-5 – RC-O-6 (3-10)	RC-O-5 – RC-O-6 (9 -10)
RC-O-9 – RC-O-12 (12-08, 9-09)	RC-O-9 – RC-O-13 (9-10)
RC-P-3 – RC-P-5 (3-08)	RC-P-3 – RC-P-5 (9 -10)
A-1 – A-4 (6-07, 9-09, 6-10)	A-1 – A-4 (9-10)
A-7 – A-8 (3-09)	A-7 – A-8 (9-10)
A-11 – A-16 (3-04, 3-05, 6-09)	A-11– A-16 (9-10)
A-25 – A-32 (6-07)	A-25 – A-32 (9-10)
A-33 – A-42 (3-03, 3-05, 3-06, 6-07, 12-09, 6-10)	A-33 – A-42 (9-10)
A-43 – A-44 (6-01)	A-43 – A-44 (9-10)
A-47 – A-52 (6-05, 6-07)	A-47 – A-52 (9-10)
A-55 – A-68 (6-02, 6-05, 9-06, 6-07, 3-09, 6-10)	A-55 – A-68 (9-10)
A-71 – A-74 (6-10)	A-71 – A-74 (9-10)
A-75 – A-80 (6-07, 3-08, 6-09, 6-10)	A-75 – A-80 (9-10)
A-85 – A-89 (6-10)	A-85 – A-89 (9-10)

GLOSSARY

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Part I. (cont.)

Memoranda

Item No.	Caption and Instructions
13	**Construction, land development, and other land loans (in domestic offices) with interest reserves.** Memorandum items 13.a and 13.b are to completed by banks that had construction, land development, and other land loans (in domestic offices) (as reported in Schedule RC-C, part I, item 1.a, column B) that exceeded 100 percent of total risk-based capital (as reported in Schedule RC-R, item 21) as of the previous December 31. For purposes of Memorandum items 13, 13.a, and 13.b, construction, land development, and other land loans (in domestic offices) are hereafter referred to as "construction loans." When a bank enters into a loan agreement with a borrower on a construction loan, an interest reserve is often included in the amount of the loan commitment to the borrower and it allows the lender to periodically advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance.
13.a	**Amount of loans that provide for the use of interest reserves.** Report the amount of construction loans included in Schedule RC-C, part I, item 1.a, column B, for which the loan agreement with the borrower provides for the use of interest reserves. If a construction loan included in Schedule RC-C, part I, item 1.a, column B, has been fully advanced or the funds budgeted for interest have been fully advanced, but the loan agreement provided for the use of interest reserves, continue to report the loan in this item even if the borrower is now paying interest from other sources of funds. Similarly, if a construction loan included in Schedule RC-C, part I, item 1.a, column B, has been renewed or extended, but the original loan agreement provided for the use of interest reserves, continue to report the loan in this item. Include in this item new construction loans (as defined for and reported in Schedule RC-C, part I, item 1.a, column B) that have been granted for the purpose of paying interest on existing construction loans (in domestic offices) when the new construction loan is secured by the same real estate that secures the existing construction loan. Exclude construction loans for which the loan agreement with the borrower does not provide for the use of interest reserves.
13.b	**Amount of interest capitalized from interest reserves on construction, land development, and other land loans that is included in interest and fee income on loans during the quarter.** Report the amount of interest advanced to borrowers on construction loans (as defined for Schedule RC-C, part I, item 1.a, column B) that has been capitalized into the borrowers' loan balances through the use of interest reserves (including interest advanced on new construction loans granted for the purpose of paying interest on existing construction loans when the loans are secured by the same real estate) and included in interest and fee income during the quarter on "All other loans secured by real estate" (Schedule RI, item 1.a.(1)(b), on the FFIEC 041; Schedule RI, item 1.a.(1)(a)(2) on the FFIEC 031). The amount of capitalized interest included in interest income during the quarter should be reduced by amounts reversed against interest during the quarter.

Part I. (cont.)

Memoranda

Item No. Caption and Instructions

14 **Pledged loans and leases.** Report the amount of all loans and leases included in Schedule RC-C, part I, above that are pledged to secure deposits, repurchase transactions, or other borrowings (regardless of the balance of the deposits or other liabilities against which the loans and leases are pledged) or for any other purpose. Include loans and leases that have been transferred in transactions that are accounted for as secured borrowings with a pledge of collateral because they do not qualify as sales under ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended). In general, the pledging of loans and leases is the act of setting aside certain loans and leases to secure or collateralize bank transactions with the bank continuing to own the loans and leases unless the bank defaults on the transaction.

When a bank is subject to a blanket lien arrangement or has otherwise pledged an entire portfolio of loans to secure its Federal Home Loan Bank advances, it should report the amount of the entire portfolio of loans subject to the blanket lien in this item. Any loans within the portfolio that have been explicitly excluded or specifically released from the lien and that the bank has the right, without constraint, to repledge to another party should not be reported as pledged in this item. However, if any such loans have been repledged to another party, they should be reported in this item.

NOTE: Memorandum item 15 is to be completed for the December report only.

15 **Reverse mortgages (in domestic offices).** A reverse mortgage is an arrangement in which a homeowner borrows against the equity in his or her home and receives cash either in a lump sum or through periodic payments. However, unlike a traditional mortgage loan, no payment is required until the borrower no longer uses the home as his or her principal residence. Cash payments to the borrower after closing, if any, and accrued interest are added to the principal balance. These loans may have caps on their maximum principal balance or they may have clauses that permit the cap on the maximum principal balance to be increased under certain circumstances. The reverse mortgage market currently consists of two basic types of products: proprietary products designed and originated by financial institutions and a federally-insured product known as a Home Equity Conversion Mortgage (HECM).

Report in the appropriate subitem the specified information about the bank's involvement with reverse mortgages (in domestic offices).

15.a **Reverse mortgages outstanding that are held for investment.** Report in the appropriate subitem the amount of HECM and proprietary reverse mortgages held for investment that are included in Schedule RC-C, part I, item 1.c, Loans "Secured by 1-4 family residential properties." A loan is held for investment if the bank has the intent and ability to hold the loan for the foreseeable future or until maturity or payoff. Exclude reverse mortgages that are held for sale.

15.a.(1) **Home Equity Conversion Mortgage (HECM) reverse mortgages.** Report the amount of HECM reverse mortgages held for investment that are included in Schedule RC-C, part I, item 1.c, Loans "Secured by 1-4 family residential properties."

15.a.(2) **Proprietary reverse mortgages.** Report the amount of proprietary reverse mortgages held for investment that are included in Schedule RC-C, part I, item 1.c, Loans "Secured by 1-4 family residential properties."

Item No.	Caption and Instructions
7.a	**One year or less.** Report all unsecured "Other borrowings" with a remaining maturity of one year or less. The unsecured "Other borrowings" that should be included in this item will also have been reported in Schedule RC-M, item 5.b.(2), "Other borrowings with a remaining maturity of one year or less."
7.b	**Over one year through three years.** Report all unsecured "Other borrowings" with a remaining maturity of over one year through three years.
7.c	**Over three years through five years.** Report all unsecured "Other borrowings" with a remaining maturity of over three years through five years.
7.d	**Over five years.** Report all unsecured "Other borrowings" with a remaining maturity of over five years.
8	**Subordinated notes and debentures with a remaining maturity of.** Report the amount of the bank's subordinated notes and debentures (as defined for Schedule RC, item 19) in the appropriate subitems according to the amount of time remaining until their final contractual maturities. Include both fixed rate and floating rate subordinated notes and debentures. The sum of Schedule RC-M, items 8.a through 8.d, must equal Schedule RC, item 19, "Subordinated notes and debentures."
8.a	**One year or less.** Report all subordinated notes and debentures with a remaining maturity of one year or less.
8.b	**Over one year through three years.** Report all subordinated notes and debentures with a remaining maturity of over one year through three years.
8.c	**Over three years through five years.** Report all subordinated notes and debentures with a remaining maturity of over three years through five years.
8.d	**Over five years.** Report all subordinated notes and debentures with a remaining maturity of over five years.
9	**Reciprocal brokered deposits.** Report the amount of reciprocal deposits included in the amount of brokered deposits reported in Schedule RC-E, (part I,) Memorandum item 1.b, "Total brokered deposits." As defined in Section 327.8(s) of the FDIC's regulations, "reciprocal deposits" are "[d]eposits that an insured depository institution receives through a deposit placement network on a reciprocal basis, such that: (1) for any deposit received, the institution (as agent for depositors) places the same amount with other insured depository institutions through the network; and (2) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members."

Memoranda

Item No. **Caption and Instruction**

1 **Total assessable deposits (in domestic offices) of the bank (and in insured branches in Puerto Rico and U.S. territories and possessions), including related interest accrued and unpaid.** Memorandum items 1.a.(1) through 1.d.(2) are to be completed each quarter. These Memorandum items should be reported on an unconsolidated single FDIC certificate number basis.

The sum of Memorandum items 1.a.(1), 1.b.(1), 1.c.(1), and 1.d.(1) must equal the bank's assessable deposits, i.e., Schedule RC-O, item 1, "Total deposit liabilities before exclusions (gross) as defined in Section 3(l) of the Federal Deposit Insurance Act and FDIC regulations," less item 2, "Total allowable exclusions, including interest accrued and unpaid on allowable exclusions (including foreign deposits)." Accordingly, all amounts included in the bank's assessable deposits, not just those included in its "Deposits in domestic offices" (reported in Schedule RC, item 13.a), should be reported in the appropriate subitem of Memorandum item 1. For example, the interest accrued and unpaid that is included in the bank's assessable deposits should be reported together with the related account in Memorandum items 1.a.(1), 1.b.(1), 1.c.(1), and 1.d.(1).

The dollar amounts used as the basis for reporting the number and amount of deposit accounts in Memorandum items 1.a.(1) through 1.d.(2) reflect the deposit insurance limits of $250,000 for "retirement deposit accounts" and $250,000 for other deposit accounts.

"Retirement deposit accounts" that are eligible for $250,000 in deposit insurance coverage are deposits made in connection with the following types of retirement plans:

- Individual Retirement Accounts (IRAs), including traditional and Roth IRAs;
- Simplified Employee Pension (SEP) plans;
- "Section 457" deferred compensation plans;
- Self-directed Keogh (HR 10) plans; and
- Self-directed defined contribution plans, which are primarily 401(k) plan accounts.

The term ''self-directed'' means that the plan participants have the right to direct how their funds are invested, including the ability to direct that the funds be deposited at an FDIC-insured institution.

Retirement deposit accounts exclude Coverdell Education Savings Accounts, formerly known as Education IRAs.

In some cases, brokered certificates of deposit are issued in $1,000 amounts under a master certificate of deposit issued by a bank to a deposit broker in an amount that exceeds $250,000. For these so-called "retail brokered deposits," multiple purchases by individual depositors from an individual bank normally do not exceed the applicable deposit insurance limit ($250,000), but under current deposit insurance rules the deposit broker is not required to provide information routinely on these purchasers and their account ownership capacity to the bank issuing the deposits. If this information is not readily available to the issuing bank, these brokered certificates of deposit in $1,000 amounts may be rebuttably presumed to be fully insured and should be reported as "Deposits accounts of $250,000 or less" in

Memoranda

Item No. **Caption and Instruction**

2 **Estimated amount of uninsured assessable deposits (in domestic offices of the bank and in insured branches in Puerto Rico and U.S. territories and possessions), including related interest accrued and unpaid.**

Schedule RC-O, Memorandum item 2, is to be completed on an unconsolidated single FDIC certificate number basis by banks with $1 billion or more in total assets.

Report the estimated amount of the bank's deposits (in domestic offices and in insured branches in Puerto Rico and U.S. territories and possessions) that is not covered by federal deposit insurance. This estimate should reflect the deposit insurance limits of $250,000 for "retirement deposit accounts" (as defined in Schedule RC-O, Memorandum item 1) and $250,000 for other deposit accounts without taking into account the bank's participation in the FDIC's Debt Guarantee Program or Transaction Account Guarantee Program. The reporting of this information is mandated by Section 7(a)(9) of the Federal Deposit Insurance Act.

The estimated amount of uninsured deposits reported in this item should be based on the bank's deposits included in Schedule RC-O, item 1, "Total deposit liabilities before exclusions (gross) as defined in Section 3(l) of the Federal Deposit Insurance Act and FDIC regulations," less item 2, "Total allowable exclusions, including interest accrued and unpaid on allowable exclusions (including foreign deposits)." In addition to the uninsured portion of deposits in "domestic offices" reported in Schedule RC, item 13.a, the estimate of uninsured deposits should take into account all other items included in Schedule RC-O, item 1 less item 2, including, but not limited to:

- Interest accrued and unpaid on deposits in domestic offices;
- Deposits in insured branches in Puerto Rico and U.S. territories and possessions (including interest accrued and unpaid on these deposits);
- Deposits of consolidated subsidiaries in domestic offices and in insured branches in Puerto Rico and U.S. territories and possessions (including interest accrued and unpaid on these deposits); and
- Deposit liabilities that have been reduced by assets netted against these liabilities in accordance with generally accepted accounting principles.

The bank's estimate of its uninsured deposits should be reported in accordance with the following criteria. In this regard, it is recognized that a bank may have multiple automated information systems for different types of deposits and that the capabilities of a bank's information systems to provide an estimate of its uninsured deposits will differ from bank to bank at any point in time and, within an individual institution, may improve over time.

(1) If the bank has brokered deposits, which must be reported in Schedule RC-E, Memorandum item 1.b, "Total brokered deposits," it must use the information it has developed for completing Schedule RC-E, Memorandum item 1.c, "Fully insured brokered deposits," to determine its best estimate of the uninsured portion of its brokered deposits.

(2) If the bank has deposit accounts whose ownership is based on a fiduciary relationship, Part 330 of the FDIC's regulations generally states that the titling of the deposit account (together with the underlying records) must indicate the existence of the fiduciary relationship in order for insurance coverage to be available on a "pass-through" basis.

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Item No. **Caption and Instruction**

2 (cont.)

Fiduciary relationships include, but are not limited to, relationships involving a trustee, agent, nominee, guardian, executor, or custodian.

A bank with fiduciary deposit accounts with balances of more than $250,000 must diligently use the available data on these deposit accounts, including data indicating the existence of different principal and income beneficiaries and data indicating that some or all of the funds on deposit represent retirement deposit accounts eligible for $250,000 in deposit insurance coverage, to determine its best estimate of the uninsured portion of these accounts.

(3) If the bank has deposit accounts of employee benefit plans, Part 330 of the FDIC's regulations states that these accounts are insured on a "pass-through" basis for the non-contingent interest of each plan participant provided that certain prescribed recordkeeping requirements are met. A bank with employee benefit plan deposit accounts with balances of more than $250,000 must diligently use the available data on these deposit accounts to determine its best estimate of the uninsured portion of these accounts.

(4) If the bank's deposit accounts include benefit-responsive "Depository Institution Investment Contracts," which must be included in Schedule RC-O, item 2, these deposit liabilities are not eligible for federal deposit insurance pursuant to Section 11(a)(8) of the Federal Deposit Insurance Act. A bank with benefit-responsive "Depository Institution Investment Contracts" must include the entire amount of these contracts in the estimated amount of uninsured deposits it reports in this Memorandum item 2.

(5) If the bank has deposit accounts with balances in excess of the federal deposit insurance limit that it has collateralized by pledging assets, such as deposits of the U.S. Government and of states and political subdivisions in the U.S. (which must be reported in Schedule RC-E, items 2 and 3, and, on the FFIEC 031 report form, in Schedule RC-E, part II, item 5), the bank should make a reasonable estimate of the portion of these deposits that is uninsured using the data available from its information systems.

(6) If the bank has deposit accounts with balances in excess of the federal deposit insurance limit for which it has acquired private deposit insurance to cover this excess amount, the bank should make a reasonable estimate of the portion of these deposits that is not insured by the FDIC using the data available from its information systems.

(7) For all other deposit accounts, the bank should make a reasonable estimate of the portion of these deposits that is uninsured using the data available from its information systems. In developing this estimate, if the bank has automated information systems in place that enable it to identify jointly owned accounts and estimate the deposit insurance coverage of these deposits, the higher level of insurance afforded these joint accounts should be taken into consideration. Similarly, if the bank has automated information systems in place that enable it to classify accounts by deposit owner and/or ownership capacity, the bank should incorporate this information into its estimate of the amount of uninsured deposits by aggregating accounts held by the same deposit owner in the same ownership capacity before applying the $250,000 insurance limit. Ownership capacities include, but are not limited to, single ownership, joint ownership, business (excluding sole proprietorships), revocable trusts, irrevocable trusts, and retirement accounts.

Memoranda

Item No. **Caption and Instruction**

2 (cont.) In the absence of automated information systems, a bank may use nonautomated information such as paper files or less formal knowledge of its depositors if such information provides reasonable estimates of appropriate portions of its uninsured deposits. A bank's use of such nonautomated sources of information is considered appropriate unless errors associated with the use of such sources would contribute significantly to an overall error in the FDIC's estimate of the amount of insured and uninsured deposits in the banking system.

3 **Has the reporting institution been consolidated with a parent bank or savings association in that parent bank's or parent savings association's Call Report or Thrift Financial Report?** If the reporting bank is owned by another bank or savings association and that parent bank or parent savings association is consolidating the reporting bank as part of the parent institution's Call Report or Thrift Financial Report for this report date, report the legal title and FDIC Certificate Number of the parent institution in this item.

Memorandum items 4.a and 4.b are to be completed by all institutions participating in the FDIC Transaction Account Guarantee Program.

4 **Noninterest-bearing transaction accounts (as defined in Part 370 of the FDIC's regulations) of more than $250,000.** For the calendar quarter ending on the report date, report in the appropriate subitem the average daily amount and the average daily number of noninterest-bearing transaction accounts with a balance of more than $250,000. An institution may exclude noninterest-bearing transaction accounts with a balance of more than $250,000 if the entire balance in the account is fully insured under the FDIC's deposit insurance rules, such as joint account relationship rules or "pass-through" insurance coverage rules. In noninterest-bearing transaction accounts with a balance of more than $250,000 where the entire balance is not fully insured, an institution may exclude any amounts over $250,000 that are otherwise insured under the FDIC's deposit insurance rules. These amounts may be excluded to the extent that they can be determined by the institution and fully supported in the institution's workpapers for this report. An institution is not required to make a determination of amounts otherwise insured but may do so at its option.

For days that an office of the reporting institution is closed (e.g., Saturdays, Sundays, or holidays), the amounts outstanding and the number of noninterest-bearing transaction accounts with a balance of more than $250,000 from the previous business day should be used in the calculation of the daily averages for the quarter.

For purposes of Memorandum items 4.a and 4.b and the FDIC's Transaction Account Guarantee Program, the term ''noninterest-bearing transaction account'' means a transaction account as defined in Federal Reserve Regulation D that is:

(1) Maintained at an insured depository institution (in a domestic office or an insured branch in Puerto Rico or a U.S. territory or possession);
(2) With respect to which interest is neither accrued nor paid; and
(3) On which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal.

Thus, the term "noninterest-bearing transaction account" includes all demand deposits, including certified checks and official checks (such as cashiers' checks and money orders) drawn on the reporting institution.

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Item No.	Caption and Instruction

4 (cont.)

In addition, for purposes of Memorandum items 4.a and 4.b and the Transaction Account Guarantee Program, the term "noninterest-bearing transaction account" also includes:

(1) Accounts commonly known as Interest on Lawyers Trust Accounts (IOLTAs) (or functionally equivalent accounts); and

(2) Negotiable order of withdrawal (NOW) accounts with interest rates no higher than 0.25 percent for which the insured depository institution at which the account is held has committed to maintain the interest rate at or below 0.25 percent.[1]

For purposes of Memorandum items 4.a and 4.b and the FDIC's Transaction Account Guarantee Program, a "noninterest-bearing transaction account" does not include, for example, a money market deposit account (MMDA) as defined in Federal Reserve Regulation D.

Account features such as the waiver of fees or the provision of fee-reducing credits do not prevent an account from qualifying as noninterest-bearing as long as the account is otherwise noninterest-bearing.

In determining whether funds are in a noninterest-bearing transaction account for purposes of Memorandum items 4.a and 4.b and the Transaction Account Guarantee Program, the FDIC will apply its normal rules and procedures under Section 360.8 of the FDIC's regulations for determining account balances at a failed insured depository institution. Under these procedures, funds may be swept or transferred from a noninterest-bearing transaction account to another type of deposit or nondeposit account. Except as described in the following sentence, unless the funds are in a noninterest-bearing transaction account after the completion of a sweep under Section 360.8, the funds will not be guaranteed under the Transaction Account Guarantee Program and they should not be reported in Memorandum items 4.a and 4.b. However, in the case of funds swept from a noninterest-bearing transaction account to a noninterest-bearing savings deposit account as defined in Federal Reserve Regulation D, the FDIC will treat the swept funds as being in a noninterest-bearing transaction account. If the sum of the swept funds in the noninterest-bearing savings deposit account plus any amount remaining in the related noninterest-bearing transaction account is more than $250,000 on a particular day during the calendar quarter ending on the report date, this sum should be included in the calculation of the average daily amount to be reported in Memorandum item 4.a and the swept funds and the related noninterest-bearing transaction account should be treated as one account when calculating the average daily number of accounts to be reported in Memorandum item 4.b.

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[1] A NOW account with an interest rate above 0.50 percent as of November 21, 2008, may be treated as a noninterest-bearing transaction account for purposes of the Transaction Account Guarantee Program if (1) through June 30, 2010, the insured depository institution at which the account is held reduced the interest rate on that account to 0.50 percent or lower before January 1, 2009, and committed to maintain that interest rate at no more than 0.50 percent through June 30, 2010, and (2) after June 30, 2010, through the expiration date of the Transaction Account Guarantee Program, the insured depository institution at which the account is held reduces the interest rate on that account to 0.25 percent or lower before July 1, 2010, and commits to maintain that interest rate at no more than 0.25 percent through the expiration date of the Transaction Account Guarantee Program.

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Item No.	Caption and Instruction
4 (cont.)	Include public funds held in noninterest-bearing transaction accounts of more than $250,000 whether or not they are collateralized with pledged securities or other pledged assets. For further information on the reporting of the average daily amount and the average daily number of noninterest-bearing transaction accounts of more than $250,000, see the "Guidance on Revised Transaction Account Guarantee Program Reporting Requirements Effective September 30, 2010" at http://www.fdic.gov/regulations/resources/TLGP/tagp-programReportingGuidance.pdf.
4.a	**Average daily amount of noninterest-bearing transaction accounts of more than $250,000.** Report the average daily amount of noninterest-bearing transaction accounts (as defined in Schedule RC-O, Memorandum item 4, above) with a balance of more than $250,000. This average daily amount can be calculated by (1) summing, for each calendar day during the quarter, the amounts of all noninterest-bearing transaction accounts with a balance of more than $250,000 on that day, (2) totaling the daily sums for all of the days during the calendar quarter, and (3) dividing the total of the daily sums by the number of calendar days in the quarter ending on the report date.
4.b	**Average daily number of noninterest-bearing transaction accounts of more than $250,000.** Report the average daily number, rounded to two decimal places, of noninterest-bearing transaction accounts (as defined in Schedule RC-O, Memorandum item 4, above) with a balance of more than $250,000. This average daily number can be calculated by (1) determining, for each calendar day during the quarter, the number of all noninterest-bearing transaction accounts with a balance of more than $250,000 on that day, (2) totaling the daily number of such accounts for all of the days during the quarter, and (3) dividing the total of the daily numbers by the number of calendar days in the quarter.

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Item No. Caption and Instructions

2.a **Closed-end first liens.** Report the principal amount of wholesale originations and purchases of closed-end first lien 1-4 family residential mortgage loans for resale during the calendar quarter.

2.b **Closed-end junior liens.** Report the principal amount of wholesale originations and purchases of closed-end junior lien 1-4 family residential mortgage loans for resale during the calendar quarter.

2.c **Open-end loans extended under lines of credit:**

2.c.(1) **Total commitment under the lines of credit.** Report the total amount of open-end commitments under wholesale originations and purchases of revolving, open-end lines of credit secured by 1-4 family residential properties for resale during the calendar quarter.

2.c.(2) **Principal amount funded under the lines of credit.** Report the total principal amount funded under open-end commitments arising from the wholesale originations of revolving, open-end lines of credit secured by 1-4 family residential properties for resale during the calendar quarter reported in item 2.c.(1) above.

3 **1-4 family residential mortgage loans sold during the quarter.** Report in the appropriate subitem closed-end and open-end 1-4 family residential mortgage loans sold during the calendar quarter ending on the report date. Include transfers of closed-end and open-end 1-4 family residential mortgage loans originated or purchased for resale from retail or wholesale sources that have been accounted for as sales in accordance with FASB Statement No. 140, i.e., those transfers where the loans are no longer included in the bank's consolidated total assets. Also include all sales during the quarter of closed-end and open-end 1-4 family residential mortgage loans directly from the bank's loan portfolio. For further information, see the Glossary entry for "transfers of financial assets."

3.a **Closed-end first liens.** Report the principal amount of closed-end first lien 1-4 family residential mortgage loans sold during the calendar quarter.

3.b **Closed-end junior liens.** Report the principal amount of closed-end junior lien 1-4 family residential mortgage loans sold during the calendar quarter.

3.c **Open-end loans extended under lines of credit:**

3.c.(1) **Total commitment under the lines of credit.** Report the total amount of open-end commitments under revolving, open-end lines of credit secured by 1-4 family residential properties sold during the calendar quarter.

3.c.(2) **Principal amount funded under the lines of credit.** Report the total principal amount funded under open-end commitments associated with the revolving, open-end lines of credit secured by 1-4 family residential properties sold during the calendar quarter reported in item 3.c.(1) above.

Item No.	Caption and Instructions
4	**<u>1–4 family residential mortgage loans held for sale at quarter-end</u>.** Report in the appropriate subitem closed-end and open-end 1-4 family residential mortgages held for sale as of the quarter-end report date and included in Schedule RC, item 4.a, “Loans and leases held for sale.” Loans held for sale should be reported at the lower of cost or fair value consistent with their presentation in the balance sheet (Schedule RC, item 4.a). Closed-end and open-end 1-4 family residential mortgage loans held for sale at quarter-end include any mortgage loans transferred at any time from the bank’s loan portfolio to a held-for-sale account that have not been sold by quarter-end.
4.a	**<u>Closed-end first liens.</u>** Report the carrying amount of closed-end first lien 1-4 family residential mortgage loans held for sale at quarter-end.
4.b	**<u>Closed-end junior liens.</u>** Report the carrying amount of closed-end junior lien 1-4 family residential mortgage loans held for sale at quarter-end.
4.c	**<u>Open-end loans extended under lines of credit:</u>**
4.c.(1)	**<u>Total commitment under the lines of credit.</u>** Report the total amount of open-end commitments under revolving, open-end lines of credit secured by 1-4 family residential properties held for sale at quarter-end.
4.c.(2)	**<u>Principal amount funded under the lines of credit.</u>** Report the total principal amount funded under open-end commitments associated with the revolving, open-end lines of credit secured by 1-4 family residential properties held for sale at quarter-end reported in item 4.c.(1) above.
5	**<u>Noninterest income for the quarter from the sale, securitization, and servicing of 1-4 family residential mortgage loans.</u>** Report in the appropriate subitem the noninterest income earned during the calendar quarter ending on the report date from mortgage banking activities involving closed-end and open-end 1-4 family residential mortgage loans. Include the portion of the consolidated bank’s “Net servicing fees,” “Net securitization income,” and “Net gains (losses) on sales of loans and leases” (items 5.f, 5.g, and 5.i of Schedule RI) earned during the quarter that is attributable to closed-end and open-end 1-4 family residential mortgage loans.
5.a	**<u>Closed-end 1-4 family residential mortgage loans.</u>** Report the noninterest income earned during the calendar quarter ending on the report date from the sale, securitization, and servicing of closed-end 1-4 family residential mortgage loans.
5.b	**<u>Open-end 1-4 family residential mortgage loans extended under lines of credit.</u>** Report the noninterest income earned during the calendar quarter ending on the report date from the sale, securitization, and servicing of revolving, open-end lines of credit secured by 1-4 family residential properties.
6	**<u>Repurchases and indemnifications of 1-4 family residential mortgage loans *during the quarter.*</u>** As a result of its 1–4 family residential mortgage banking activities, a bank may be obligated to repurchase mortgage loans that it has sold or otherwise indemnify the loan purchaser against loss because of borrower defaults, loan defects, other breaches of representations and warranties, or for other reasons. Report in the appropriate subitem all 1-4 family residential mortgage loans previously sold by the bank or a consolidated subsidiary subject to an obligation to repurchase or indemnify that have been repurchased or indemnified during the calendar quarter ending on the report date. Do not reduce this amount by any third-party indemnifications or reimbursements that the bank has received.

Item No.	Caption and Instructions
6 (cont.)	Repurchased 1-4 family residential mortgage loans include loans that the bank (or a consolidated subsidiary) had sold but subsequently repurchased under repurchase obligation provisions of the sales agreement because of a delinquency, noncompliance with the sellers' representations and warranties, fraud or misrepresentation, or any other contractual requirement. Exclude 1-4 family residential mortgage loans that have been repurchased solely at the discretion of the bank (such as delinquent mortgage loans backing GNMA mortgage-backed securities), i.e., where the sales agreement contains a repurchase option (which may be conditional), but not a repurchase obligation. Indemnifications of 1-4 family residential mortgage loans are limited to reimbursements to loan purchasers or other third parties for credit losses on loans that the bank (or a consolidated subsidiary) has sold. Include reimbursements made on loans where the bank has agreed with the purchaser or other third party not to repurchase the loan as required under the sales agreement, but rather to guarantee that no credit loss is sustained. Indemnifications also include loans for which payments have been made by the bank (or a consolidated subsidiary) to purchasers or other third parties as reimbursements for deficiency balances arising from sales of real estate collateral (whether or not foreclosed) on loans that the bank (or a consolidated subsidiary) has sold. Exclude indemnification arrangements that are limited to reimbursements of legal fees or administrative costs.
6.a	**Closed-end first liens.** Report the total principal amount outstanding as of the date of repurchase or indemnification of closed-end first lien 1-4 family residential mortgage loans previously sold by the bank or a consolidated subsidiary that have been repurchased or indemnified during the calendar quarter ending on the report date.
6.b	**Closed-end junior liens.** Report the total principal amount outstanding as of the date of repurchase or indemnification of closed-end junior lien 1-4 family residential mortgage loans previously sold by the bank or a consolidated subsidiary that have been repurchased or indemnified during the calendar quarter ending on the report date.
6.c	**Open-end loans extended under lines of credit:**
6.c.(1)	**Total commitment under the lines of credit.** Report the total amount of open-end commitments under revolving, open-end lines of credit secured by 1-4 family residential properties that have been repurchased or indemnified during the calendar quarter ending on the report date.
6.c.(2)	**Principal amount funded under the lines of credit.** Report the total principal amount funded under open-end commitments associated with the revolving, open-end lines of credit secured by 1-4 family residential properties reported in item 6.c.(1) above that have been repurchased or indemnified during the calendar quarter ending on the report date.

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GLOSSARY

The definitions in this Glossary apply to the Reports of Condition and Income and are not necessarily applicable for other regulatory or legal purposes. Similarly, the accounting discussions in this Glossary are those relevant to the preparation of these reports and are not intended to constitute a comprehensive presentation on bank accounting. For purposes of this Glossary, the FASB Accounting Standards Codification is referred to as "ASC."

Acceptances: See "bankers acceptances."

Accounting Changes: Changes in accounting principles – The accounting principles that banks have adopted for the preparation of their Reports of Condition and Income should be changed only if (a) the change is required by a newly issued accounting pronouncement or (b) the bank can justify the use of an allowable alternative accounting principle on the basis that it is preferable when there are two or more generally accepted accounting principles for a type of event or transaction. If a bank changes from the use of one acceptable accounting principle to one that is more preferable at any time during the calendar year, it must report the income or expense item(s) affected by the change for the entire year on the basis of the newly adopted accounting principle regardless of the date when the change is actually made. However, a change from an accounting principle that is neither accepted nor sanctioned by bank supervisors to one that is acceptable to supervisors is to be reported as a correction of an error as discussed below.

New accounting pronouncements that are adopted by the Financial Accounting Standards Board (or such other body officially designated to establish accounting principles) generally include transition guidance on how to initially apply the pronouncement. In general, the pronouncements require (or allow) a bank to use one of the following approaches, collectively referred to as "retrospective application":

- Apply a different accounting principle to one or more previously issued financial statements; or
- Make a cumulative-effect adjustment to retained earnings, assets, and/or liabilities at the beginning of the period as if that principle had always been used.

Because each Report of Income covers a single discrete period, only the second approach under retrospective application is permitted in the Reports of Condition and Income. Therefore, when an accounting pronouncement requires the application of either of the approaches under retrospective application, banks must report the effect on the amount of retained earnings at the beginning of the year in which the new pronouncement is first adopted for purposes of the Reports of Condition and Income (net of applicable income taxes, if any) as a direct adjustment to equity capital in Schedule RI-A, item 2, and describe the adjustment in Schedule RI-E, item 4.

In the Reports of Condition and Income in which a change in accounting principle is first reflected, the bank is encouraged to include an explanation of the nature and reason for the change in accounting principle in Schedule RI-E, item 7, "Other explanations," or in the "Optional Narrative Statement Concerning the Amounts Reported in the Reports of Condition and Income."

Changes in accounting estimates – Accounting and the preparation of financial statements involve the use of estimates. As more current information becomes known, estimates may be changed. In particular, accruals are derived from estimates based on judgments about the outcome of future events and changes in these estimates are an inherent part of accrual accounting.

Reasonable changes in accounting estimates do not require the restatement of amounts of income and expenses and assets, liabilities, and capital reported in previously submitted Reports of Condition and Income. Computation of the cumulative effect of these changes is also not ordinarily necessary. Rather, the effect of such changes is handled on a prospective basis. That is, beginning in the period

Accounting Changes (cont.):

when an accounting estimate is revised, the related item of income or expense for that period is adjusted accordingly. For example, if the bank's estimate of the remaining useful life of certain bank equipment is increased, the remaining undepreciated cost of the equipment would be spread over its revised remaining useful life. Similarly, immaterial accrual adjustments to items of income and expenses, including provisions for loan and lease losses and income taxes, are considered changes in accounting estimates and would be taken into account by adjusting the affected income and expense accounts for the year in which the adjustments were found to be appropriate.

However, large and unusual changes in accounting estimates may be more properly treated as constituting accounting errors, and if so, must be reported accordingly as described below.

Corrections of accounting errors – A bank may become aware of an error in a Report of Condition or Report of Income after it has been submitted to the appropriate federal bank regulatory agency through either its own or its regulator's discovery of the error. An error in the recognition, measurement, or presentation of an event or transaction included in a report for a prior period may result from:

- A mathematical mistake;
- A mistake in applying accounting principles; or
- The oversight or misuse of facts that existed when the Reports of Condition and Income for prior periods were prepared.

According to SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108) (Topic 1.N. in the Codification of Staff Accounting Bulletins), the effects of prior year errors or misstatements ("carryover effects") should be considered when quantifying misstatements identified in current year financial statements. SAB 108 describes two methods for accumulating and quantifying misstatements. These methods are referred to as the "rollover" and "iron curtain" approaches:

- The rollover approach "quantifies a misstatement based on the amount of the error originating in the current year income statement" only and ignores the "carryover effects" of any related prior year misstatements. The primary weakness of the rollover approach is that it fails to consider the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years.

- The iron curtain approach "quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year(s) of origination." The primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year financial statements to be errors because the prior year misstatements were considered immaterial in the year(s) of origination. Thus, there could be a material misstatement in the current year income statement because the correction of the accumulated immaterial amounts from prior years is not evaluated as an error.

Because of the weaknesses in these two approaches, SAB 108 states that the impact of correcting all misstatements on current year financial statements should be accomplished by quantifying an error under both the rollover and iron curtain approaches and by evaluating the error measured under each approach. When either approach results in a misstatement that is material, after considering all relevant quantitative and qualitative factors, an adjustment to the financial statements would be required. Guidance on the consideration of all relevant factors when assessing the materiality of misstatements is provided in SEC Staff Accounting Bulletin No. 99, *Materiality* (SAB 99) (Topic 1.M. in the Codification of Staff Accounting Bulletins).

Accounting Changes (cont.):

For purposes of the Reports of Condition and Income, all banks should follow the sound accounting practices described in SAB 108 and SAB 99. Accordingly, banks should quantify the impact of correcting misstatements, including both the carryover and reversing effects of prior year misstatements, on their current year reports by applying both the “rollover” and “iron curtain” approaches and evaluating the impact of the error measured under each approach. When the misstatement that exists after recording the adjustment in the current year Reports of Condition and Income is material (considering all relevant quantitative and qualitative factors), the appropriate prior year report(s) should be amended, even though such revision previously was and continues to be immaterial to the prior year report(s). If the misstatement that exists after recording the adjustment in the current year Reports of Condition and Income is not material, then amending the immaterial errors in prior year reports would not be necessary.

When a bank's primary federal bank regulatory agency determines that the bank's Reports of Condition and Income contain a material accounting error, the bank may be directed to file amended condition and/or income report data for each prior period that was significantly affected by the error. Normally, such refilings will not result in restatements of reports for periods exceeding five years. If amended reports are not required, the bank should report the effect of such corrections on retained earnings at the beginning of the year, net of applicable income taxes, in Schedule RI-A, item 2, "Cumulative effect of changes in accounting principles and corrections of material accounting errors," and in Schedule RI-E, item 4. The effect of such corrections on income and expenses since the beginning of the year in which the error is discovered should be reflected in each affected income and expense account on a year-to-date basis in the next quarterly Report of Income to be filed and not as a direct adjustment to retained earnings.

In addition, a change from an accounting principle that is neither accepted nor sanctioned by bank supervisors to one that is acceptable to supervisors is to be reported as a correction of an error. When such a change is implemented, the cumulative effect that applies to prior periods, calculated in the same manner as described above for other changes in accounting principles, should be reported in Schedule RI-A, item 2, "Cumulative effect of changes in accounting principles and corrections of material accounting errors," and in Schedule RI-E, item 4. In most cases of this kind undertaken voluntarily by the reporting bank in order to adopt more acceptable accounting practices, such a change will not result in a request for amended reports for prior periods unless substantial distortions in the bank's previously reported results are in evidence.

In the Reports of Condition and Income in which the correction of an error is first reflected, the bank is encouraged to include an explanation of the nature and reason for the correction in Schedule RI-E, item 7, “Other explanations,” or in the “Optional Narrative Statement Concerning the Amounts Reported in the Reports of Condition and Income.”

For further information on these three topics, see ASC Topic 250, Accounting Changes and Error Corrections (formerly FASB Statement No. 154, "Accounting Changes and Error Corrections").

Accounting Errors, Corrections of: See "accounting changes."

Accounting Estimates, Changes in: See "accounting changes."

Accounting Principles, Changes in: See "accounting changes."

<u>Accrued Interest Receivable Related to Credit Card Securitizations:</u> In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal (credit card purchases and cash advances), finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale under ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended), the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet. The "accrued interest receivable" (AIR) asset typically consists of the seller's retained interest in the investor's portion of (1) the accrued fees and finance charges that have been billed to customer accounts, but have not yet been collected ("billed but uncollected"), and (2) the right to finance charges that have been accrued on cardholder accounts, but have not yet been billed ("accrued but unbilled").

While the selling institution retains a right to the excess cash flows generated from the fees and finance charges collected on the transferred receivables, the institution generally subordinates its right to these cash flows to the investors in the securitization. If and when cash payments on the accrued fees and finance charges are collected, they flow through the trust, where they are available to satisfy more senior obligations before any excess amount is remitted to the seller. Only after trust expenses (such as servicing fees, investor certificate interest, and investor principal charge-offs) have been paid will the trustee distribute any excess fee and finance charge cash flow back to the seller. Since investors are paid from these cash collections before the selling institution receives the amount of AIR that is due, the seller may or may not realize the full amount of its AIR asset.

<u>Accounting at Inception of the Securitization Transaction</u> **–** Generally, if a securitization transaction meets the criteria for sale treatment and the AIR is subordinated either because the asset has been isolated from the transferor[1] or because of the operation of the cash flow distribution (or "waterfall") through the securitization trust, the total AIR asset (both the "billed and uncollected" and "accrued and unbilled") should be considered one of the components of the sale transaction. Thus, when accounting for a credit card securitization, an institution should allocate the previous carrying amount of the AIR (net of any related allowance for uncollectible amounts) and the other transferred assets between the assets that are sold and the retained interests, based on their relative fair values at the date of transfer. As a result, after a securitization, the allocated carrying amount of the AIR asset will typically be lower than its face amount.

<u>Subsequent Accounting</u> **–** After securitization, the AIR asset should be accounted for at its allocated cost basis (as discussed above). In addition, an institution should treat the AIR asset as a retained (subordinated) beneficial interest. Accordingly, it should be reported as an "All other asset" in Schedule RC-F, item 6, and in Schedule RC-S, item 2.b, column C, (if reported as a stand-alone asset) and not as a loan receivable.

Although the AIR asset is a retained beneficial interest in transferred assets, it is not required to be subsequently measured like an investment in debt securities classified as available for sale or trading under ASC Topic 320, Investments-Debt and Equity Securities (formerly FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities") and ASC Topic 860 because the AIR asset cannot be contractually prepaid or settled in such a way that the holder would not recover substantially all of its recorded investment. Rather, institutions should follow existing applicable accounting standards, including ASC Subtopic 450-20, Contingencies – Loss Contingencies (formerly FASB Statement No. 5, *Accounting for Contingencies*), in subsequent accounting for the AIR asset. ASC Subtopic 450-20 addresses the accounting for various loss contingencies, including the collectibility of receivables.

For further guidance, banks should refer to the Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations dated December 4, 2002. <u>See also</u> the Glossary entry for "Transfers of Financial Assets."

[1] See ASC Subtopic 860-10.

Acquisition, Development, or Construction (ADC) Arrangements: An ADC arrangement is an arrangement in which a bank provides financing for real estate acquisition, development, or construction purposes and participates in the expected residual profit resulting from the ultimate sale or other use of the property. ADC arrangements should be reported as loans, real estate joint ventures, or direct investments in real estate in accordance with ASC Subtopic 310-10, Receivables – Overall (formerly AICPA Practice Bulletin 1, Appendix, Exhibit I, “ADC Arrangements”).

12 USC 29 limits the authority of national banks to hold real estate. National banks should review real estate ADC arrangements carefully for compliance. State member banks are not authorized to invest in real estate except with the prior approval of the Federal Reserve Board under Federal Reserve Regulation H (12 CFR Part 208). In certain states, nonmember banks may invest in real estate.

Agreement Corporation: See "Edge and Agreement corporation."

Allowance for Loan and Lease Losses: Each bank must maintain an allowance for loan and lease losses (allowance) at a level that is appropriate to cover estimated credit losses associated with its loan and lease portfolio, i.e., loans and leases that the bank has intent and ability to hold for the foreseeable future or until maturity or payoff. Each bank should also maintain, as a separate liability account, an allowance at a level that is appropriate to cover estimated credit losses associated with off-balance sheet credit instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees. This separate allowance 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 loan and lease losses" in Schedule RC, item 4.c.

With respect to the loan and lease portfolio, the term "estimated credit losses" means an estimate of the current amount of loans and leases that it is probable the bank will be unable to collect given facts and circumstances as of the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or pool of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., through a provision to the allowance) set forth in generally accepted accounting principles (GAAP).

As of the end of each quarter, or more frequently if warranted, the management of each bank must evaluate, subject to examiner review, the collectibility of the loan and lease portfolio, including any recorded accrued and unpaid interest (i.e., not already reversed or charged off), and make entries to maintain the balance of the allowance for loan and lease losses on the balance sheet at an appropriate level. Management must maintain reasonable records in support of their evaluations and entries. Furthermore, each bank is responsible for ensuring that controls are in place to consistently determine the allowance for loan and lease losses in accordance with GAAP (including ASC Subtopic 450-20, Contingencies – Loss Contingencies (formerly FASB Statement No. 5, "Accounting for Contingencies") and ASC Topic 310, Receivables (formerly FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"), the bank's stated policies and procedures, management's best judgment and relevant supervisory guidance.

Additions to, or reductions of, the allowance account resulting from such evaluations are to be made through charges or credits to the "provision for loan and lease losses" (provision) in the Report of Income. When available information confirms that specific loans and leases, or portions thereof, are uncollectible, these amounts should be promptly charged off against the allowance. All charge-offs of loans and leases shall be charged directly to the allowance. Under no circumstances can loan or lease losses be charged directly to "Retained earnings." Recoveries on loans and leases represent collections on amounts that were previously charged off against the allowance. Recoveries shall be credited to the allowance, provided, however, that the total amount credited to the allowance as recoveries on an individual loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the allowance on that loan. Any amounts collected in excess of this limit should be recognized as income.

ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer") prohibits a bank from "carrying over" or creating loan loss allowances in the initial accounting for "purchased impaired loans," i.e., loans that a bank has purchased where there is evidence of deterioration of credit quality since the origination of the loan and it is probable, at the purchase date, that the bank will be unable to collect all contractually required payments receivable. This prohibition applies to the purchase of an individual impaired loan, a pool or group of impaired loans, and impaired loans acquired in a purchase business combination. However, if, upon evaluation subsequent to acquisition, based on current information and events, it is probable that the bank is unable to collect all cash flows expected at acquisition (plus additional cash flows expected to be collected arising from changes in estimate after acquisition) on a purchased impaired loan (not accounted for as a debt security), the loan should be considered impaired for purposes of establishing an allowance pursuant to ASC Subtopic 450-20 or ASC Topic 310, as appropriate.

When a bank makes a full or partial direct write-down of a loan or lease that is uncollectible, the bank establishes a new cost basis for the asset. Consequently, once a new cost basis has been established for a loan or lease through a direct write-down, this cost basis may not be "written up" at a later date. Reversing the previous write-down and "re-booking" the charged-off asset after the bank concludes

Allowance for Loan and Lease Losses (cont.):
that the prospects for recovering the charge-off have improved, regardless of whether the bank assigns a new account number to the asset or the borrower signs a new note, is not an acceptable accounting practice.

The allowance account must never have a debit balance. If losses charged off exceed the amount of the allowance, a provision sufficient to restore the allowance to an appropriate level must be charged to expense on the income statement immediately. A bank shall not increase the allowance account by transferring an amount from undivided profits or any segregation thereof to the allowance for loan and lease losses.

To the extent that a bank's reserve for bad debts for tax purposes is greater than or less than its "allowance for loan and lease losses" on the balance sheet of the Report of Condition, the difference is referred to as a temporary difference. See the Glossary entry for "income taxes" for guidance on how to report the tax effect of such a temporary difference.

Recourse liability accounts that arise from recourse obligations for any transfers of loans that are reported as sales for purposes of these reports should not be included in the allowance for loan and lease losses. These accounts are considered separate and distinct from the allowance account and from the allowance for credit losses on off-balance sheet credit exposures. Recourse liability accounts should be reported in Schedule RC-G, item 4, "All other liabilities."

For comprehensive guidance on the maintenance of an appropriate allowance for loan and lease losses, banks should refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses dated December 13, 2006. For guidance on the design and implementation of allowance methodologies and supporting documentation practices, banks should refer to the interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations, which was published on July 6, 2001. National banks should also refer to the Office of the Comptroller of the Currency's Handbook for National Bank Examiners discussing the allowance for loan and lease losses. Information on the application of ASC Topic 310, Receivables, to the determination of an allowance for loan and lease losses on those loans covered by that accounting standard is provided in the Glossary entry for "loan impairment."

For information on reporting on foreclosed and repossessed assets, see the Glossary entry for "foreclosed assets."

Applicable Income Taxes: See "income taxes."

Associated Company: See "subsidiaries."

ATS Account: See "deposits."

Bankers Acceptances: A banker's acceptance, for purposes of these reports, is a draft or bill of exchange that has been drawn on and accepted by a banking institution (the "accepting bank") or its agent for payment by that institution at a future date that is specified in the instrument. Funds are advanced to the drawer of the acceptance by the discounting of the accepted draft either by the accepting bank or by others; the accepted draft is negotiable and may be sold and resold subsequent to its original discounting. At the maturity date specified, the holder or owner of the acceptance at that date, who has advanced funds either by initial discount or subsequent purchase, presents the accepted draft to the accepting bank for payment.

The accepting bank has an unconditional obligation to put the holder in funds (to pay the holder the face amount of the draft) on presentation on the specified date. The account party (customer) has an unconditional obligation to put the accepting bank in funds at or before the maturity date specified in the instrument.

Bankers Acceptances (cont.):

In Schedule RC-C, part I, the reporting bank's holdings of other banks' acceptances, other than those held for trading, are to be reported in "Loans to depository institutions and acceptances of other banks" (item 2). On the other hand, the bank's holdings of its own acceptances, other than those held for trading, are to be reported in Schedule RC-C, part I, according to the account party of the draft. Thus, holdings of own acceptances for which the account parties are commercial or industrial enterprises are to be reported in Schedule RC-C, part I, in "Commercial and industrial loans" (item 4); holdings of own acceptances for which the account parties are other banks (e.g., in connection with the refinancing of another acceptance or for the financing of dollar exchange) are to be reported in Schedule RC-C, part I, in "Loans to depository institutions and acceptances of other banks" (item 2); and holdings of own acceptances for which the account parties are foreign governments or official institutions (e.g., for the financing of dollar exchange) are to be reported in Schedule RC-C, part I, "Loans to foreign governments and official institutions" (item 7).

The difference in treatment between holdings of own acceptances and holdings of other banks' acceptances reflects the fact that, for other banks' acceptances, the holding bank's immediate claim is on the accepting bank, regardless of the account party or of the purpose of the loan. On the other hand, for its holdings of its own acceptances, the bank's immediate claim is on the account party named in the accepted draft.

If the account party prepays its acceptance liability on an acceptance of the reporting bank that is held by the reporting bank (in the held-for-sale account, in the loan portfolio, or as trading assets) so as to immediately reduce its indebtedness to the reporting bank, the recording of the holding – in "Commercial and industrial loans," "Loans to depository institutions and acceptances of other banks," or "Trading assets," as appropriate – is reduced by the prepayment.

Bank-Owned Life Insurance: ASC Subtopic 325-30, Investments-Other – Investments in Insurance Contracts (formerly FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, and Emerging Issues Task Force (EITF) Issue No. 06-5, *Accounting for Purchases of Life Insurance–Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4)* addresses the accounting for bank-owned life insurance. According to ASC Subtopic 325-30, only the amount that could be realized under the insurance contract as of the balance sheet date should be reported as an asset. In general, this amount is the cash surrender value reported to the institution by the insurance carrier less any applicable surrender charges not reflected by the insurance carrier in the reported cash surrender value, i.e., the net cash surrender value. An institution should also consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract in accordance with ASC Subtopic 325-30.

Because there is no right of offset, an investment in bank-owned life insurance should be reported as an asset separately from any related deferred compensation liability.

Banks that have entered into split-dollar life insurance arrangements should follow the guidance on the accounting for the deferred compensation and postretirement benefit aspects of such arrangements in ASC Subtopic 715-60, Compensation-Retirement Benefits – Defined Benefit Plans-Other Postretirement (formerly EITF Issue No. 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements,” and EITF Issue No. 06-10, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements”). In general, in an endorsement split-dollar arrangement, a bank owns and controls the insurance policy on the employee, whereas in a collateral assignment split-dollar arrangement, the employee owns and controls the insurance policy. According to ASC Subtopic 715-60, a bank should recognize a liability for the postretirement benefit related to a split-dollar life insurance arrangement if, based on the substantive agreement with the employee, the bank has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death

Bank-Owned Life Insurance (cont.):

benefit. This liability should be measured in accordance with either ASC Topic 715, Compensation-Retirement Benefits (formerly FASB Statement No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions”) (if, in substance, a postretirement benefit plan exists) or ASC Subtopic 710-10, Compensation-General – Overall (formerly Accounting Principles Board Opinion No. 12, “Omnibus Opinion – 1967,” as amended by FASB Statement No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions”) (if the arrangement is, in substance, an individual deferred compensation contract), and reported on the balance sheet in Schedule RC, item 20, “Other liabilities,” and in Schedule RC-G, item 4, "All other liabilities." In addition, for a collateral assignment split-dollar arrangement, ASC Subtopic 715-60 states that an employer such as a bank should recognize and measure an insurance asset based on the nature and substance of the arrangement.

The amount that could be realized under bank-owned life insurance policies as of the report date should be reported on the balance sheet in Schedule RC, item 11, “Other assets,” and in Schedule RC-F, item 5, “Life insurance assets.” The net earnings (losses) on or the net increases (decreases) in the bank’s life insurance assets should be reported in the income statement in Schedule RI, item 5.l, "Other noninterest income." Alternatively, the gross earnings (losses) on or increases (decreases) in these life insurance assets may be reported in Schedule RI, item 5.l, and the life insurance policy expenses may be reported in Schedule RI, Item 7.d, "Other noninterest expense." If the absolute value of the earnings (losses) on or the increases (decreases) in the bank’s life insurance assets are reported in Schedule RI, item 5.l, “Other noninterest income,” are greater than $25,000 and exceed 3 percent of “Other noninterest income,” this amount should be reported in Schedule RI-E, item 1.b.

Banks, U.S. and Foreign: In the classification of banks as customers of the reporting bank, distinctions are drawn for purposes of the Reports of Condition and Income between "U.S. banks" and "commercial banks in the U.S." and between "foreign banks" and "banks in foreign countries." Some report items call for one set of these categories and other items call for the other set. The distinctions center around the inclusion or exclusion of foreign branches of U.S. banks and U.S. branches and agencies of foreign banks. For purposes of describing the office location of banks as customers of the reporting bank, the term "United States" covers the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. (This is in contrast to the usage with respect to the offices of the reporting bank, where U.S.-domiciled Edge and Agreement subsidiaries and IBFs are included in "foreign" offices. Furthermore, for banks chartered and headquartered in the 50 states of the United States and the District of Columbia, offices of the reporting bank in Puerto Rico and U.S. territories and possessions are also included in “foreign” offices, but, for banks chartered and headquartered in Puerto Rico and U.S. territories and possessions, offices of the reporting bank in Puerto Rico and U.S. territories and possessions are included in “domestic” offices.)

U.S. banks – The term "U.S. banks" covers both the U.S. and foreign branches of banks chartered and headquartered in the U.S. (including U.S.-chartered banks owned by foreigners), but excluding U.S. branches and agencies of foreign banks. On the other hand, the term "banks in the U.S." or "commercial banks in the U.S." (the institutional coverage of which is described in detail later in this entry) covers the U.S. offices of U.S. banks (including their IBFs) and the U.S. branches and agencies of foreign banks, but excludes the foreign branches of U.S. banks.

Foreign banks – Similarly, the term "foreign banks" covers all branches of banks chartered and headquartered in foreign countries (including foreign banks owned by U.S. nationals and institutions), including their U.S.-domiciled branches and agencies, but excluding the foreign branches of U.S. banks. In contrast, the term "banks in foreign countries" covers foreign-domiciled branches of banks, including the foreign branches of U.S. banks, but excluding the U.S. branches and agencies of foreign banks.

Business Combinations: The accounting and reporting standards for business combinations are set forth in ASC Topic 805, Business Combinations (formerly FASB Statement No. 141 (revised 2007), "Business Combinations"). ASC Topic 805 requires that all business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, must be accounted for using the acquisition method. The use of the pooling-of-interests method to account for business combinations is prohibited. ASC Topic 805 applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to the formation of a joint venture, the acquisition of assets that do not constitute a business, or a combination between entities under common control. Except for some business combinations between two or more mutual institutions, business combinations for which the acquisition date was before the beginning of the first annual reporting period beginning on or after December 15, 2008, were accounted for using the purchase method as specified in former FASB Statement No. 141, “Business Combinations,” which has been superseded by ASC Topic 805.

Acquisition method – Under the acquisition method, the acquirer in a business combination shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values (with limited exceptions specified in ASC Topic 805) using the definition of fair value in ASC Topic 820, Fair Value Measurements and Disclosures (formerly FASB Statement No. 157, “Fair Value Measurements”). The acquisition date is generally the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree, i.e., the closing date. ASC Topic 805 requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values and the acquirer may not recognize a separate valuation allowance (e.g., allowance for loan and lease losses) for the contractual cash flows that are deemed to be uncollectible at that date. The consideration transferred in a business combination shall be calculated as the sum of the acquisition-date fair values of the assets (including any cash) transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. Acquisition-related costs are costs the acquirer incurs to effect a business combination such as finder’s fees; advisory, legal, accounting, valuation, and other professional or consulting fees; and general administrative costs. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services received. The cost to register and issue debt or equity securities shall be recognized in accordance with other applicable generally accepted accounting principles.

ASC Topic 805 provides guidance for recognizing particular assets acquired and liabilities assumed. Acquired assets may be tangible (such as securities or fixed assets) or intangible (as discussed in the following paragraph). An acquiring entity must not recognize the goodwill, if any, or the deferred income taxes recorded by an acquired entity before its acquisition. However, a deferred tax liability or asset must be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with ASC Topic 740, Income Taxes (formerly FASB Statement No. 109, "Accounting for Income Taxes," and FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes”). (For further information, see the Glossary entry for "income taxes.")

Under ASC Topic 805, an intangible asset must be recognized as an asset separately from goodwill if it arises from contractual or other legal rights (regardless of transferability or separability). Otherwise, an intangible asset must be recognized as an asset separately from goodwill only if it is separable, that is, it 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. Examples of intangible assets that must be recognized as an asset separately from goodwill are core deposit intangibles, purchased credit card relationships, servicing assets, favorable leasehold rights, trademarks, trade names, internet domain names, and noncompetition agreements. These intangible assets must be reported in Schedule RC, item 10.b, "Other intangible assets," and in Schedule RC-M, item 2.

Business Combinations (cont.):

In general, the excess of the sum of the consideration transferred in a business combination plus the fair value of any noncontrolling interest in the acquiree over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with ASC Topic 805 must be recognized as goodwill, which is reported in Schedule RC, item 10.a. An acquired intangible asset that does not meet the criteria described in the preceding paragraph must be included in the amount recognized as goodwill. After initial recognition, goodwill must be accounted for in accordance with ASC Topic 350, Intangibles-Goodwill and Other (formerly FASB Statement No. 142, "Goodwill and Other Intangible Assets") and the instructions for Schedule RI, item 7.c.(1), "Goodwill impairment losses."

In contrast, if the total acquisition-date amount of the identifiable net assets acquired exceeds the consideration transferred plus the fair value of any noncontrolling interest in the acquiree (i.e., a bargain purchase), the acquirer shall reassess whether it has correctly identified all of the assets acquired and all the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. If that excess remains after the review, the acquirer shall recognize that excess in earnings as a gain attributable to the acquirer on the acquisition date and report the amount in Schedule RI, item 5.l, "Other noninterest income."

Under the acquisition method, the historical equity capital balances of the acquired business are *not* to be carried forward to the balance sheet of the combined bank. The operating results of the acquired bank or business are to be included in the income and expenses of the reporting bank only from the acquisition date.

Push down accounting – Push down accounting is the establishment of a new accounting basis for a bank in its separate financial statements as a result of it becoming substantially wholly owned via a purchase transaction or a series of purchase transactions. Under push down accounting, when a bank becomes substantially wholly owned, yet retains its separate corporate existence, the bank's identifiable assets, liabilities, and any noncontrolling interests are restated to their acquisition-date fair values (with limited exceptions specified in ASC Topic 805) using the definition of fair value in ASC Topic 820. If the ownership interests in the bank were acquired in a series of purchase transactions, the previously held equity interest in the bank by the parent is remeasured at its acquisition-date fair value and any resulting gain or loss is recognized in the parent's earnings. These values, including any goodwill, are reflected in the separate financial statements of the acquired bank as well as in any consolidated financial statements of the bank's parent.

Push down accounting is required for purposes of the Reports of Condition and Income if a bank's voting stock becomes at least 95 percent owned, directly or indirectly, by an investor (which may be a holding company) or a group of investors working collaboratively, and the bank does not have outstanding publicly traded debt or preferred stock that may impact the investor's or group of investors' ability to control the form of ownership. Push down accounting also is required if the bank's separate financial statements are presented on a push down basis in reports filed with the Securities and Exchange Commission. Push down accounting may also be used when a bank's voting stock becomes at least 80 percent, but less than 95 percent, owned by an investor or a group of investors working collaboratively. When determining whether a bank has become substantially wholly owned, it is appropriate to aggregate the holdings of those investors who both "mutually promote" the acquisition and "collaborate" on the subsequent control of the acquired bank (the collaborative group).

In all cases, the bank's primary federal supervisory authority reserves the right to determine whether or not a bank must use push down accounting for purposes of the Reports of Condition and Income.

Business Combinations (cont.):

When push down accounting is used by a bank in the preparation of its Reports of Condition and Income, both of the following conditions should be met:

(1) An arm's-length purchase acquisition or series of purchase transactions resulting in the bank becoming substantially wholly owned (at least 80 percent) must have occurred, and

(2) The push down adjusting entries must eliminate the retained earnings account (therefore, the entire retained earnings of the bank before it became substantially wholly owned will not be available for the payment of dividends after it became substantially wholly owned).

In the Reports of Condition and Income for the remainder of the year in which a bank applies push down accounting after becoming substantially wholly owned, the bank shall report the initial increase or decrease in its equity capital that results from the application of push down accounting in item 7, "Changes incident to business combinations, net," of Schedule RI-A, Changes in Bank Equity Capital. In addition, when push down accounting is used, no income or expense for the period of the calendar year prior to the date the bank became substantially wholly owned should be included in subsequent Reports of Income.

For further information, see ASC Subtopic 805-50, Business Combinations – Related Issues (formerly EITF Topic D-97, *Push-Down Accounting*).

Pooling-of-interests method – Under the pooling-of-interests method, the assets, liabilities, and capital of the bank and the business being acquired are added together on a line-by-line basis without any adjustments for fair value. The historical cost-based amount (cost adjusted for amortization of premiums and discounts or depreciation) of each asset, liability, and capital account of the acquiring bank is added to the corresponding account of the business being acquired to arrive at the balance sheet for the combined bank. However, the capital stock outstanding of the combined bank must be equal to the number of shares issued and outstanding (including the shares issued in connection with the acquisition) multiplied by par or stated value.

If the sum of the capital stock accounts of the entities being combined does not equal this amount (and it rarely, if ever, will), adjustment is required. If the sum of the capital stock accounts is less than the number of shares outstanding of the combined bank multiplied by par or stated value, "Surplus," Schedule RC, item 25, must be debited for the amount of the difference and "Common stock," Schedule RC, item 24, is credited. If the surplus account is insufficient to absorb such an adjustment, the remainder must be debited to "Retained earnings," Schedule RC, item 26.a. If the sum of the capital stock accounts is more than the amount of the outstanding stock of the combined bank, "Surplus" must be credited and "Common stock" debited.

Any adjustments necessary to conform the accounting methods of the acquired entity to those of the reporting bank must be made, net of related tax effects, to "Retained earnings."

For the year in which a pooling of interests occurs, income and expenses must be reported in Schedule RI, Income Statement, as though the companies had combined at the beginning of the year. The portion of the adjustment necessary to conform the accounting methods applicable to the current period must also be allocated to income and expenses for the period.

Reorganization **–** A combination of two or more entities or businesses involving related parties, i.e., entities under common control, is considered a reorganization and not a business combination. For example, two subsidiary banks of a bank holding company may combine into one bank, which is a change in legal organization but not a change in the entity. The assets and liabilities transferred in the combination are accounted for at historical cost in a manner similar to that described above under

Business Combinations (cont.):
"pooling-of-interests method." For the year in which a reorganization occurs, income and expenses must be reported in Schedule RI, Income Statement, as though the entities had combined at the beginning of the year.

A bank holding company's investment in a bank or other business that was acquired in a business combination accounted for under the acquisition method may differ from the book value of the net assets in that bank's or business's financial statements because push down accounting was not applied. This situation will generally exist with respect to acquisitions that occurred prior to the September 30, 1989, effective date of the push down accounting instructions set forth above in this Glossary entry.

A bank holding company may transfer its ownership interest in an acquired bank or other business to another one of its subsidiary banks subsequent to its acquisition of the bank or other business. When this occurs, the financial statements of the surviving bank must be adjusted, as set forth in ASC Subtopic 852-10, Reorganizations – Overall (formerly EITF Issue No. 90-5, “Exchanges of Ownership Interests between Entities under Common Control”) to reflect the assets and liabilities of the acquired bank or other business at the historical cost included in the holding company's financial statements. The necessity and extent of such adjustments should be determined in consultation with the bank's primary federal supervisory authority.

For further information on the accounting for business combinations, see ASC Topic 805.

Call Option: See "derivative contracts."

Capitalization of Interest Costs: Interest costs associated with the construction of a building shall, if material, be capitalized as part of the cost of the building. Such interest costs include both the actual interest incurred when the construction funds are borrowed and the interest costs imputed to internal financing of a construction project.

The interest rate utilized to capitalize interest on internally financed projects in a reporting period shall be the rate(s) applicable to the bank's borrowings outstanding during the period. For this purpose, a bank's borrowings include interest-bearing deposits and other interest-bearing liabilities.

The interest capitalized shall not exceed the total amount of interest cost incurred by the bank during the reporting period.

For further information, see ASC Subtopic 835-20, Interest – Capitalization of Interest (formerly FASB Statement No. 34, "Capitalization of Interest Costs," as amended).

Carrybacks and Carryforwards: See "income taxes."

Cash Management Arrangements: A cash management arrangement is a group of related transaction accounts of a single type maintained in the same right and capacity by a customer (a single legal entity), whereby the customer and the financial institution understand that payments from one account will be honored so long as a net credit balance exists in the group of related transaction accounts taken as a whole. Such accounts function as, and will be regarded for reporting and deposit insurance assessment purposes as, one account rather than separate accounts, provided adequate documentation of the arrangement is maintained as discussed below. (Note: For reporting and deposit insurance assessment purposes, transaction accounts of affiliates and subsidiaries of a parent company that are separate legal entities may not be offset because accounts of separate legal entities are not permitted within a bona fide cash management arrangement.)

Cash Management Arrangements (cont.):
"Transaction accounts of a single type" means demand deposit accounts or NOW accounts, but not a combination thereof. For purposes of cash management arrangements, the terms "right" and "capacity" relate to the form of legal ownership such as being held in an agency or trust capacity, as a joint tenant, or as an individual. "Single legal entity" means a natural person, partnership, corporation, trust, or estate.

The reporting bank must maintain readily available records that will allow for the verification of cash management arrangements. Such documentation must provide account numbers, account titles, ownership of accounts, and the terms and conditions surrounding the management of the accounts, and must also clearly show that both the customer and the reporting bank have agreed to such terms and conditions. These terms and conditions must clearly indicate the understanding that payments from one account will be honored as long as a net credit balance exists within the group of related transaction accounts taken as a whole and maintained in the same right and capacity. A written cash management agreement, signed by both the customer (a single legal entity) and the reporting bank, accurately maintained and incorporating the above information, will be acceptable evidence of a bona fide cash management arrangement. In addition, the reporting bank must maintain readily available records that will allow for the verification of account balances within cash management arrangements.

See "deposits" for the definitions of transaction account, demand deposit, and NOW account. See also "overdraft."

Certificate of Deposit: See "deposits."

Changes in Accounting Estimates: See "accounting changes."

Changes in Accounting Principles: See "accounting changes."

Clearing Accounts: See "suspense accounts."

Commercial Banks in the U.S.: See "banks, U.S. and foreign."

Commercial Letter of Credit: See "letter of credit."

Commercial Paper: Commercial paper consists of short-term negotiable promissory notes issued in the United States by commercial businesses, including finance companies and banks. Commercial paper usually matures in 270 days or less and is not collateralized. Commercial paper may be backed by a standby letter of credit from a bank, as in the case of documented discounted notes. Holdings of commercial paper are to be reported as "securities" in Schedule RC-B, normally in item 6, "Other debt securities," unless held for trading and therefore reportable in Schedule RC, item 5, "Trading assets."

Commodity or Bill-of-Lading Draft: A commodity or bill-of-lading draft is a draft that is issued in connection with the shipment of goods. If the commodity or bill-of-lading draft becomes payable only when the shipment of goods against which it is payable arrives, it is an arrival draft. Arrival drafts are usually forwarded by the shipper to the collecting depository institution with instructions to release the shipping documents (e.g., bill of lading) conveying title to the goods only upon payment of the draft. Payment, however, cannot be demanded until the goods have arrived at the drawee's destination. Arrival drafts provide a means of insuring payment of shipped goods at the time that the goods are released.

Common Stock of Unconsolidated Subsidiaries, Investments in: See “equity method of accounting” and "subsidiaries."

Continuing Contract: See "federal funds transactions."

Corporate Joint Venture: See "subsidiaries."

Corrections of Accounting Errors: See "accounting changes."

Coupon Stripping, Treasury Receipts, and STRIPS: Coupon stripping occurs when a security holder physically detaches unmatured coupons from the principal portion of a security and sells either the detached coupons or the ex-coupon security separately. (Such transactions are generally considered by federal bank supervisory agencies to represent "improper investment practices" for banks.) In accounting for such transactions, the carrying amount of the security must be allocated between the ex-coupon security and the detached coupons based on their relative fair values at the date of the sale in accordance with ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended). (See the Glossary entry for "transfers of financial assets.")

Detached U.S. Government security coupons and ex-coupon U.S. Government securities that are held for purposes other than trading, whether resulting from the coupon stripping activities of the reporting bank or from its purchase of stripped securities, shall be reported as "Other domestic debt securities" in Schedule RC-B, item 6.a. The amount of any discount or premium relating to the detached coupons or ex-coupon securities must be amortized. (See the Glossary entry for "premiums and discounts.")

A variation of coupon stripping has been developed by several securities firms which have marketed instruments with such names as CATS (Certificates of Accrual on Treasury Securities), TIGR (Treasury Investment Growth Receipts), COUGAR (Certificates on Government Receipts), LION (Lehman Investment Opportunity Notes), and ETR (East Treasury Receipts). A securities dealer purchases U.S. Treasury securities, delivers them to a trustee, and sells receipts representing the rights to future interest and/or principal payments on the U.S. Treasury securities held by the trustee. Such Treasury receipts are not an obligation of the U.S. Government and, when held for purposes other than trading, shall be reported as "Other domestic debt securities" in Schedule RC-B, item 6.a. The discount on these Treasury receipts must be accreted.

Under a program called Separate Trading of Registered Interest and Principal of Securities (STRIPS), the U.S. Treasury has issued certain long-term note and bond issues that are maintained in the book-entry system operated by the Federal Reserve Banks in a manner that permits separate trading and ownership of the interest and principal payments on these issues. Even after the interest or principal portions of U.S. Treasury STRIPS have been separately traded, they remain obligations of the U.S. Government. STRIPS held for purposes other than trading shall be reported as U.S. Treasury securities in Schedule RC-B, item 1. The discount on separately traded portions of STRIPS must be accreted.

Detached coupons, ex-coupon securities, Treasury receipts, and U.S. Treasury STRIPS held for trading purposes shall be reported at fair value in Schedule RC, item 5.

Custody Account: A custody account is one in which securities or other assets are held by a bank on behalf of a customer under a safekeeping arrangement. Assets held in such capacity are not to be reported in the balance sheet of the reporting bank nor are such accounts to be reflected as a liability. Assets of the reporting bank held in custody accounts at other banks are to be reported on the reporting bank's balance sheet in the appropriate asset categories as if held in the physical custody of the reporting bank.

Dealer Reserve Account: A dealer reserve account arises when a bank purchases at full face value a dealer's installment note receivables, but credits less than the full face value directly to the dealer's account. The remaining amount is credited to a separate dealer reserve account. That account is held by the bank as collateral for the installment notes and, for reporting purposes, is treated as a deposit in the appropriate items of Schedule RC-E. The bank will subsequently disburse to the dealer predetermined portions of the reserve as the purchased notes are paid in a timely manner.

Dealer Reserve Account (cont.):

For example, if a bank purchases $100,000 in notes from a dealer for the full face amount ($100,000) and pays to the dealer $90,000 in cash or credits to his/her deposit account, the remaining $10,000, which is held as collateral security, would be credited to the dealer reserve account.

See also "deposits."

Deferred Compensation Agreements: Institutions often enter into deferred compensation agreements with selected employees as part of executive compensation and retention programs. These agreements are generally structured as nonqualified retirement plans for federal income tax purposes and are based upon individual agreements with selected employees. Institutions purchase life insurance in connection with many of these agreements. Bank-owned life insurance may produce attractive tax-equivalent yields that offset some or all of the costs of the agreements.

Deferred compensation agreements with select employees under individual contracts generally do not constitute postretirement income plans (i.e., pension plans) or postretirement health and welfare benefit plans. The accounting for individual contracts that, when taken together, do not represent a postretirement plan should follow ASC Subtopic 710-10, Compensation-General – Overall (formerly Accounting Principles Board Opinion No. 12, “Omnibus Opinion – 1967,” as amended by FASB Statement No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions”). If the individual contracts, taken together, are equivalent to a plan, the plan should be accounted for under ASC Topic 715, Compensation-Retirement Benefits (formerly FASB Statement No. 87, "Employers’ Accounting for Pensions," or Statement No. 106).

ASC Subtopic 710-10 requires that an employer’s obligation under a deferred compensation agreement be accrued according to the terms of the individual contract over the required service period to the date the employee is fully eligible to receive the benefits, i.e., the “full eligibility date.” Depending on the individual contract, the full eligibility date may be the employee’s expected retirement date, the date the employee entered into the contract, or a date between these two dates. ASC Subtopic 710-10 does not prescribe a specific accrual method for the benefits under deferred compensation contracts, stating only that the “cost of those benefits shall be accrued over that period of the employee’s service in a systematic and rational manner.” The amounts to be accrued each period should result in a deferred compensation liability at the full eligibility date that equals the then present value of the estimated benefit payments to be made under the individual contract.

ASC Subtopic 710-10 does not specify how to select the discount rate to measure the present value of the estimated benefit payments. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. For purposes of these reports, an institution’s incremental borrowing rate[1] and the current rate of return on high-quality fixed-income debt securities[2] are acceptable discount rates to measure deferred compensation agreement obligations. An institution must select and consistently apply a discount rate policy that conforms with generally accepted accounting principles.

For each deferred compensation agreement to be accounted for in accordance with ASC Subtopic 710-10, an institution should calculate the present value of the expected future benefit payments under the agreement at the employee’s full eligibility date. The expected future benefit payments can be

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[1] ASC Subtopic 835-30, Interest – Imputation of Interest (formerly APB Opinion No. 21,"Interest on Receivables and Payables," paragraph 13), states in part that “the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction.”

[2] Paragraph 186 in the Basis for Conclusions of former FASB Statement No. 106 states that “[t]he objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due.”

Deferred Compensation Agreements (cont.):

reasonably estimated and should be based on reasonable and supportable assumptions. The estimated amount of these benefit payments should be discounted because the benefits will be paid in periodic installments after the employee retires.

For deferred compensation agreements commonly referred to as revenue neutral or indexed retirement plans,[3] the expected future benefits should include both the "primary benefit" and, if the employee is entitled to "excess earnings" that are earned after retirement, the "secondary benefit." The number of periods the primary and any secondary benefit payments should be discounted may differ because the discount period for each type of benefit payment should be based upon the length of time during which each type of benefit will be paid as specified in the deferred compensation agreement.

After the present value of the expected future benefit payments has been determined, an institution should accrue an amount of compensation expense and a liability each year from the date the employee enters into the deferred compensation agreement until the full eligibility date. The amount of these annual accruals should be sufficient to ensure that a deferred compensation liability equal to the present value of the expected benefit payments is recorded by the full eligibility date. Any method of deferred compensation accounting that does not recognize some expense in each year from the date the employee enters into the agreement until the full eligibility date is not systematic and rational. (For indexed retirement plans, some expense should be recognized for the primary benefit and any secondary benefit in each of these years.)

Vesting provisions should be reviewed to ensure that the full eligibility date is properly determined because this date is critical to the measurement of the liability estimate. Because ASC Subtopic 710-10 requires that the present value of the expected benefit payments be recorded by the full eligibility date, institutions also need to consider changes in market interest rates to appropriately measure deferred compensation liabilities. Therefore, institutions should periodically review their estimates of the expected future benefits under deferred compensation agreements and the discount rates used to compute the present value of the expected benefit payments and revise the estimates and rates, when appropriate.

Deferred compensation agreements may include noncompete provisions or provisions requiring employees to perform consulting services during postretirement years. If the value of the noncompete provisions cannot be reasonably and reliably estimated, no value should be assigned to the noncompete provisions in recognizing the deferred compensation liability. Institutions should allocate a portion of the future benefit payments to consulting services to be performed in postretirement years only if the consulting services are determined to be substantive. Factors to consider in determining whether postretirement consulting services are substantive include, but are not limited to, whether the services are required to be performed, whether there is an economic benefit to the institution, and whether the employee forfeits the benefits under the agreement for failure to perform such services.

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[3] Revenue neutral and indexed retirement plans are deferred compensation agreements that are typically designed so that the spread each year, if any, between the tax-equivalent earnings on bank-owned life insurance covering an individual employee and a hypothetical earnings calculation is deferred and paid to the employee as a postretirement benefit. This spread is commonly referred to as “excess earnings.” The hypothetical earnings are computed based on a pre-defined variable index rate (e.g., cost of funds or federal funds rate) times a notional amount. The agreement for this type of plan typically requires the excess earnings that accrue before an employee’s retirement to be recorded in a separate liability account. Once the employee retires, the balance in the liability account is generally paid to the employee in equal annual installments over a set number of years (e.g., 10 or 15 years). These payments are commonly referred to as the “primary benefit” or “preretirement benefit.” The employee may also receive the excess earnings that are earned after retirement. This benefit may continue until his or her death and is commonly referred to as the “secondary benefit” or “postretirement benefit.” The secondary benefit is paid annually, once the employee has retired, in addition to the primary benefit.

Deposits (cont.):

(b) Noninterest-bearing deposit accounts consist of deposit accounts on which the issuing depository institution pays no compensation to the holder for the use of the funds.

Noninterest-bearing deposit accounts include (i) matured time deposits that are not automatically renewable (unless the deposit agreement provides for the funds to be transferred at maturity to another type of account) and (ii) deposits with a zero percent stated interest rate that are issued at face value.

See also "brokered deposits" and "hypothecated deposits."

Examples Illustrating Distinctions Between
MONEY MARKET DEPOSIT ACCOUNTS (MMDAs) and OTHER SAVINGS DEPOSITS

Example 1

A savings deposit account permits no transfers of any type to other accounts or to third parties. Report this account as an other savings deposit.

Example 2

A savings deposit permits up to six, but no more than six, "preauthorized, automatic, or telephonic" transfers to other accounts or to third parties. None of the third-party payments may be made by check, draft, or similar order (including debit card).
Report this account as an other savings deposit.

Example 3

A savings deposit permits no more than six "preauthorized, automatic, or telephonic" transfers to other accounts or to third parties. Up to three, but no more than three, of the six transfers may be by check, draft, debit card or similar order made by the depositor and payable to third parties.
Report this account as an MMDA.

Example 4

A savings deposit permits up to three, but no more than three, "preauthorized, automatic, or telephonic" transfers to other accounts or to third parties, any or all which may be by check, draft, debit card or similar order made by the depositor and payable to third parties.
Report this account as an MMDA.

Derivative Contracts: Banks commonly use derivative instruments for managing (positioning or hedging) their exposure to market risk (including interest rate risk and foreign exchange risk), cash flow risk, and other risks in their operations and for trading. The accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities are set forth in ASC Topic 815, Derivatives and Hedging (formerly FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended), which banks must follow for purposes of these reports. ASC Topic 815 requires all derivatives to be recognized on the balance sheet as either assets or liabilities at their fair value. A summary of the principal provisions of ASC Topic 815 follows. For further information, see ASC Topic 815, which includes the implementation guidance issued by the FASB's Derivatives Implementation Group.

<u>Derivative Contracts (cont.):</u>

<u>Definition of Derivative</u>

ASC Topic 815 defines a "derivative instrument" as a financial instrument or other contract with all three of the following characteristics:

(1) It has one or more underlyings (i.e., specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable) and one or more notional amounts (i.e., number of currency units, shares, bushels, pounds, or other units specified in the contract) or payment provisions or both. These terms determine the amount of the settlement or settlements, and in some cases, whether or not a settlement is required.

(2) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have similar response to changes in market factors.

(3) Its terms require or permit net settlement, it can be readily settled net by a 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.

Certain contracts that may meet the definition of a derivative are specifically excluded from the scope of ASC Topic 815, including:

- "regular-way" securities trades, which are trades that are completed within the time period generally established by regulations and conventions in the marketplace or by the exchange on which the trade is executed;
- normal purchases and sales of an item other than a financial instrument or derivative instrument (e.g., a commodity) that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business;
- traditional life insurance and property and casualty contracts; and
- certain financial guarantee contracts.

ASC Topic 815 has special criteria for determining whether commitments to originate loans meet the definition of a derivative. Commitments to originate mortgage loans that will be held for sale are accounted for as derivatives. Commitments to originate mortgage loans that will be held for investment are not accounted for as derivatives. Also, all commitments to originate loans other than mortgage loans are not accounted for as derivatives. Commitments to purchase loans must be evaluated to determine whether the commitment meets the definition of a derivative under ASC Topic 815.

<u>Types of Derivatives</u>

The most common types of freestanding derivatives are forwards, futures, swaps, options, caps, floors, and collars.

<u>Forward contracts</u> are agreements that obligate two parties to purchase (long) and sell (short) a specific financial instrument, foreign currency, or commodity at a specified price with delivery and settlement at a specified future date.

Derivative Contracts (cont.):

Futures contracts are standardized forward contracts that are traded on organized exchanges. Exchanges in the U.S. are registered with and regulated by the Commodity Futures Trading Commission. The deliverable financial instruments underlying interest-rate future contracts are specified investment-grade financial instruments, such as U.S. Treasury securities or mortgage-backed securities. Foreign currency futures contracts involve specified deliverable amounts of a particular foreign currency. The deliverable products under commodity futures contracts are specified amounts and grades of commodities such as gold bullion. Equity futures contracts are derivatives that have a portion of their return linked to the price of a particular equity or to an index of equity prices, such as the Standard and Poor's 500.

Other forward contracts are traded over the counter and their terms are not standardized. Such contracts can only be terminated, other than by receipt of the underlying asset, by agreement of both buyer and seller. A forward rate agreement is a forward contract that specifies a reference interest rate and an agreed on interest rate (one to be paid and one to be received), an assumed principal amount (the notional amount), and a specific maturity and settlement date.

Swap contracts are forward-based contracts in which two parties agree to swap streams of payments over a specified period. The payments are based on an agreed upon notional principal amount. An interest rate swap generally involves no exchange of principal at inception or maturity. Rather, the notional amount is used to calculate the payment streams to be exchanged. However, foreign exchange swaps often involve the exchange of principal.

Option contracts (standby contracts) are traded on exchanges and over the counter. Option contracts grant the right, but do not obligate, the purchaser (holder) to buy (call) or sell (put) a specific or standard commodity, financial, or equity instrument at a specified price during a specified period or at a specified date. A purchased option is a contract in which the buyer has paid compensation (such as a fee or premium) to acquire the right to sell or purchase an instrument at a stated price on a specified future date. A written option obligates the option seller to purchase or sell the instrument at the option of the buyer of the contract. Option contracts may relate to purchases or sales of securities, money market instruments, futures contracts, other financial instruments, or commodities.

Interest rate caps are option contracts in which the cap seller, in return for a premium, agrees to limit the cap holder's risk associated with an increase in interest rates. If rates go above a specified interest-rate level (the strike price or cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. For example, an issuer of floating-rate debt may purchase a cap to protect against rising interest rates, while retaining the ability to benefit from a decline in rates.

Interest rate floors are option contracts in which the floor seller, in return for a premium, agrees to limit the risk associated with a decline in interest rates based on a notional amount. If rates fall below an agreed rate, the floor holder will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate, multiplied by the notional principal amount.

Interest rate collars are option contracts that combine a cap and a floor (one held and one written). Interest rate collars enable a user with a floating rate contract to lock into a predetermined interest-rate range often at a lower cost than a cap or a floor.

Embedded Derivatives

Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments. Embedded derivatives are implicit or explicit terms within a contract that affect some or all of the cash flows or

Derivative Contracts (cont.):

the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more of the underlyings.

An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument, i.e., bifurcated, if and only if all three of the following conditions are met:

(1) The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract,

(2) The contract ("the hybrid instrument") that embodies the embedded derivative and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur, and

(3) A separate instrument with the same terms as the embedded derivative instrument would be a considered a derivative.

An embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

(1) The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment, or

(2) The embedded derivative could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Examples of hybrid instruments (not held for trading purposes) with embedded derivatives which meet the three conditions listed above and must be accounted for separately include debt instruments (including deposit liabilities) whose return or yield is indexed to: changes in an equity securities index (e.g., the Standard & Poor's 500); changes in the price of a specific equity security; or changes in the price of gold, crude oil, or some other commodity. For purposes of these reports, when an embedded derivative must be accounted for separately from the host contract under ASC Topic 815, the carrying value of the host contract and the fair value of the embedded derivative may be combined and presented together on the balance sheet in the asset or liability category appropriate to the host contract.

Under ASC Subtopic 815-15, Derivatives and Hedging – Embedded Derivatives (formerly FASB Statement No. 155, "Accounting for Certain Hybrid Financial Instruments"), a bank with a hybrid instrument for which bifurcation would otherwise be required is permitted to irrevocably elect to initially and subsequently measure the hybrid instrument in its entirety at fair value with changes in fair value recognized in earnings. In addition, ASC Subtopic 815-15 subjects all but the simplest forms of interest-only and principal-only strips and all forms of beneficial interests in securitized financial assets to the requirements of ASC Topic 815. Thus, a bank must evaluate such instruments to identify those that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. However, a beneficial interest that contains a concentration of credit risk in the form of subordination to another financial instrument and certain securitized interests in prepayable financial assets are not considered to contain embedded derivatives that must be

<u>Derivative Contracts (cont.):</u>

accounted for separately from the host contract. For further information, see ASC Subtopic 815-15, Derivatives and Hedging – Embedded Derivatives (formerly Derivatives Implementation Group Issue No. B40, "Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets").

Except in limited circumstances, interest-only and principal-only strips and beneficial interests in securitized assets that were recognized prior to the effective date (or early adoption date) of ASC Subtopic 815-15 are not subject to evaluation for embedded derivatives under ASC Topic 815.

<u>Recognition of Derivatives and Measurement of Derivatives and Hedged Items</u>

A bank should recognize all of its derivative instruments on its balance sheet as either assets or liabilities at fair value. As defined in ASC Topic 820, Fair Value Measurements and Disclosures (formerly FASB Statement No. 157, "Fair Value Measurements"), 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. For further information, see the Glossary entry for "fair value."

The accounting for changes in the fair value (that is, gains and losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as a hedging instrument. The proportion must be expressed as a percentage of the entire derivative. Gains and losses on derivative instruments are accounted for as follows:

(1) <u>No hedging designation</u> – The gain or loss on a derivative instrument not designated as a hedging instrument, including all derivatives held for trading purposes, is recognized currently in earnings.

Derivative Contracts (cont.):

(2) Fair value hedge – For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment, which is referred to as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the risk being hedged should be recognized currently.

(3) Cash flow hedge – For a derivative designated as hedging the exposure to variable cash flows of an existing recognized asset or liability or a forecasted transaction, which is referred to as a cash flow hedge, the effective portion of the gain or loss on the derivative should initially be reported outside of earnings as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument, if any, (i.e., the ineffective portion of the gain or loss and any component of the gain or loss excluded from the assessment of hedge effectiveness) should be recognized currently in earnings.

(4) Foreign currency hedge – For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported outside of earnings in other comprehensive income as part of the cumulative translation adjustment. For a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security, the accounting for a fair value hedge should be applied. Similarly, for a derivative designated as a hedge of the foreign currency exposure of a foreign-currency denominated forecasted transaction, the accounting for a cash flow hedge should be applied.

To qualify for hedge accounting, the risk being hedged must represent an exposure to an institution's earnings. In general, if the hedged item is a financial asset or liability, the designated risk being hedged can be (1) all risks, i.e., the risk of changes in the overall fair value of the hedged item or the risk of overall changes in the hedged cash flows; (2) the risk of changes in the fair value or cash flows of the hedged item attributable to changes in the benchmark interest rate;[1] (3) the risk of changes in the fair value or cash flows of the hedged item attributable to changes in foreign exchange rates; or (4) the risk of changes in the fair value or cash flows of the hedged item attributable to changes in the obligor's creditworthiness. For held-to-maturity securities, only credit risk, foreign exchange risk, or both may be hedged.

Designated hedging instruments and hedged items qualify for fair value or cash flow hedge accounting if all of the criteria specified in ASC Topic 815 are met. These criteria include:

(1) At inception of the hedge, there is formal documentation of the hedging relationship and the institution's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness will be assessed. There must be a reasonable basis for how the institution plans to assess the hedging instrument's effectiveness.

(2) Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or offsetting cash flows attributable to the hedged risk during the period that the hedge is designated or the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

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[1] The benchmark interest rate is a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. In theory, this should be a risk-free rate. In the U.S., interest rates on U.S. Treasury securities and the LIBOR swap rate are considered benchmark interest rates.

Derivative Contracts (cont.):

In a fair value hedge, an asset or a liability is eligible for designation as a hedged item if the hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment, the hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof), and certain other criteria specified in ASC Topic 815 are met. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

In a cash flow hedge, the individual cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are both referred to as a forecasted transaction. Thus, a forecasted transaction is eligible for designation as a hedged transaction if the forecasted transaction is specifically identified as a single transaction or a group of individual transactions, the occurrence of the forecasted transaction is probable, and certain other criteria specified in ASC Topic 815 are met. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged.

An institution should discontinue prospectively its use of fair value or cash flow hedge accounting for an existing hedge if any of the qualifying criteria for hedge accounting is no longer met; the derivative expires or is sold, terminated, or exercised; or the institution removes the designation of the hedge. When this occurs for a cash flow hedge, the net gain or loss on the derivative should remain in “Accumulated other comprehensive income” and be reclassified into earnings in the periods during which the hedged forecasted transaction affects earnings. However, if it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter (except as noted in ASC Topic 815), the derivative gain or loss reported in “Accumulated other comprehensive income” should be reclassified into earnings immediately.

For a fair value hedge, in general, if a periodic assessment of hedge effectiveness indicates noncompliance with the highly effective criterion that must be met in order to qualify for hedge accounting, an institution should not recognize adjustment of the carrying amount of the hedged item for the change in the item’s fair value attributable to the hedged risk after the last date on which compliance with the effectiveness criterion was established.

With certain limited exceptions, a nonderivative instrument, such as a U.S. Treasury security, may not be designated as a hedging instrument.

Reporting Derivative Contracts

When an institution enters into a derivative contract, it should classify the derivative as either held for trading or held for purposes other than trading (end-user derivatives) based on the reasons for entering into the contract. All derivatives must be reported at fair value on the balance sheet (Schedule RC).

Trading derivatives with positive fair values should be reported as trading assets in Schedule RC, item 5. Trading derivatives with negative fair values should be reported as trading liabilities in Schedule RC, item 15. Changes in the fair value (that is, gains and losses) of trading derivatives should be recognized currently in earnings and included in Schedule RI, item 5.c, “Trading revenue.”

<u>Derivative Contracts (cont.):</u>

Freestanding derivatives held for purposes other than trading (and embedded derivatives that are accounted for separately under ASC Topic 815, which the bank has chosen to present separately from the host contract on the balance sheet) that have positive fair values should be included in Schedule RC-F, item 6, "All other assets." If the total fair value of these derivatives exceeds 25 percent of "All other assets," this amount should be disclosed in Schedule RC-F, item 6.c. Freestanding derivatives held for purposes other than trading (and embedded derivatives that are accounted for separately under ASC Topic 815, which the bank has chosen to present separately from the host contract on the balance sheet) that have negative fair values should be included in Schedule RC-G, item 4, "All other liabilities." If the total fair value of these derivatives exceeds 25 percent of "All other liabilities," this amount should be disclosed in Schedule RC-G, item 4.d. Net gains (losses) on derivatives held for purposes other than trading that are not designated as hedging instruments should be recognized currently in earnings and reported consistently as either “Other noninterest income” or “Other noninterest expense” in Schedule RI, item 5.l or item 7.d, respectively.

Netting of derivative assets and liabilities is prohibited on the balance sheet except as permitted under ASC Subtopic 210-20, Balance Sheet – Offsetting (formerly FASB Interpretation No. 39, “Offsetting of Amounts Related to Certain Contracts”). <u>See</u> the Glossary entry for "offsetting."

Banks must report the notional amounts of their derivative contracts (both freestanding derivatives and embedded derivatives that are accounted for separately from their host contract under ASC Topic 815) by risk exposure in Schedule RC-L, first by type of contract in Schedule RC-L, item 12, and then by purpose of contract (i.e., trading, other than trading) in Schedule RC-L, items 13 and 14. Banks must then report the gross fair values of their derivatives, both positive and negative, by risk exposure and purpose of contract in Schedule RC-L, item 15. However, these items exclude credit derivatives, the notional amounts and gross fair values of which must be reported in Schedule RC-L, item 7.

<u>Discounts</u>: <u>See</u> "premiums and discounts."

<u>Dividends</u>: <u>Cash dividends</u> are payments of cash to stockholders in proportion to the number of shares they own. Cash dividends on preferred and common stock are to be reported on the date they are declared by the bank's board of directors (the declaration date) by debiting "retained earnings" and crediting "dividends declared not yet payable," which is to be reported in other liabilities. Upon payment of the dividend, "dividends declared not yet payable" is debited for the amount of the cash dividend with an offsetting credit, normally in an equal amount, to "dividend checks outstanding" which is reportable in the "demand deposits" category of the bank's deposit liabilities.

A liability for dividends payable may <u>not</u> be accrued in advance of the formal declaration of a dividend by the board of directors. However, the bank may segregate a portion of retained earnings in the form of a net worth reserve in anticipation of the declaration of a dividend.

<u>Stock dividends</u> are distributions of additional shares to stockholders in proportion to the number of shares they own. Stock dividends are to be reported by transferring an amount equal to the fair value of the additional shares issued from retained earnings to a category of permanent capitalization (common stock and surplus). However, the amount transferred from retained earnings must be reduced by the amount of any mandatory and discretionary transfers previously made (such as those from retained earnings to surplus for increasing the bank's legal lending limit) provided such transfers have not already been used to record a stock dividend. In any event, the amount transferred from retained earnings may not be less than the par or stated value of the additional shares being issued.

<u>Property dividends</u>, also known as dividends in kind, are distributions to stockholders of assets other than cash. The transfer of securities of other companies, real property, or any other asset owned by the reporting bank to a stockholder or related party is to be recorded at the fair value of the asset on

<u>Equity-Indexed Certificates of Deposit:</u> Under ASC Topic 815, Derivatives and Hedging (formerly FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended), a certificate of deposit that pays "interest" based on changes in an equity securities index is a hybrid instrument with an embedded derivative that must be accounted for separately from the host contract, i.e., the certificate of deposit. For further information, see the Glossary entry for "Derivative Contracts." Examples of equity-indexed certificates of deposit include the "Index Powered® CD" and the "Dow Jones Industrials Indexed Certificate of Deposit."

At the maturity date of a typical equity-indexed certificate of deposit, the holder of the certificate of deposit receives the original amount invested in the deposit plus some or all of the appreciation, if any, in an index of stock prices over the term of the certificate of deposit. Thus, the equity-indexed certificate of deposit contains an embedded equity call option. To manage the market risk of its equity-indexed certificates of deposit, a bank that issues these deposits normally enters into one or more separate freestanding equity derivative contracts with an overall term that matches the term of the certificates of deposit. At maturity, these separate derivatives are expected to provide the bank with a cash payment in an amount equal to the amount of appreciation, if any, in the same stock price index that is embedded in the certificates of deposit, thereby providing the bank with the funds to pay the "interest" on the equity-indexed certificates of deposit. During the term of the separate freestanding equity derivative contracts, the bank will periodically make either fixed or variable payments to the counterparty on these contracts.

When a bank issues an equity-indexed certificate of deposit, it must either account for the written equity call option embedded in the deposit separately from the certificate of deposit host contract or irrevocably elect to account for the hybrid instrument (the equity-indexed certificate of deposit) in its entirety at fair value.

- If the bank accounts for the written equity call option separately from the certificate of deposit, the fair value of this embedded derivative on the date the certificate of deposit is issued must be deducted from the amount the purchaser invested in the deposit, creating a discount on the certificate of deposit that must be amortized to interest expense over the term of the deposit using the effective interest method. This interest expense should be reported in the income statement in the appropriate subitem of Schedule RI, item 2.a, "Interest on deposits." The equity call option must be "marked to market" at least quarterly with any changes in the fair value of the option recognized in earnings. On the balance sheet, the carrying value of the certificate of deposit host contract and the fair value of the embedded equity derivative may be combined and reported together as a deposit liability on the balance sheet (Schedule RC) and in the deposit schedule (Schedule RC-E).

- If the bank elects to account for the equity-indexed certificate of deposit in its entirety at fair value, no discount is to be recorded on the certificate of deposit. Rather, the equity-indexed certificate of deposit must be "marked to market" at least quarterly, with changes in the instrument's fair value reported in the income statement consistently in either item 5.l, "Other noninterest income," or item 7.d, "Other noninterest expense", excluding interest expense incurred that is reported in the appropriate subitem of Schedule RI, item 2.a, "Interest on deposits."

As for the separate freestanding derivative contracts the bank enters into to manage its market risk, these derivatives must be carried on the balance sheet as assets or liabilities at fair value and "marked to market" at least quarterly with changes in their fair value recognized in earnings. The fair value of the freestanding derivatives should not be netted against the fair value of the embedded equity derivatives for balance sheet purposes because these two derivatives have different counterparties. The periodic payments to the counterparty on these freestanding derivatives must be accrued with the expense reported in earnings along with the change in the derivative's fair value. In the income statement (Schedule RI), the changes in the fair value of the embedded and freestanding derivatives, including the effect of the accruals for the payments to the counterparty on the freestanding derivatives, should be netted and reported consistently in either item 5.l, "Other noninterest income," or item 7.d, "Other noninterest expense."

Equity-Indexed Certificates of Deposit (cont.):

Unless the bank elects to account for the equity-indexed certificate of deposit in its entirety at fair value, the notional amount of the embedded equity call option must be reported in Schedule RC-L, item 12.d.(1), column C, and item 14, column C, and its fair value (which will always be negative or zero, but not positive) must be reported in Schedule RC-L, item 15.b.(2), column C. The notional amount of the freestanding equity derivative must be reported in the appropriate subitem of Schedule RC-L, item 12, column C (e.g., item 12.e, column C, if it is an equity swap), and in Schedule RC-L, item 14, column C. The fair value of the freestanding equity derivative must be included in the appropriate subitem of Schedule RC-L, item 15.b, column C. The equity derivative embedded in the equity-indexed certificate of deposit is a written option, which is not covered by the agencies' risk-based capital standards. However, the freestanding equity derivative is covered by these standards.

For deposit insurance assessment purposes, if the carrying value of the certificate of deposit host contract and the fair value of the embedded equity derivative are combined and reported together as a deposit liability on the balance sheet, the difference between these combined amounts and the face amount of the certificate of deposit should be treated as an unamortized premium or discount, as appropriate, for purposes of reporting total deposit liabilities in Schedule RC-O, item 1. If these two amounts are not combined and only the carrying value of the certificate of deposit host contract is reported as a deposit liability on the balance sheet, the difference between the carrying value and the face amount of the certificate of deposit should be treated as an unamortized discount in Schedule RC-O, item 1. If the bank elects to account for the equity-indexed certificate of deposit in its entirety at fair value, the difference between the fair value and the face amount of the certificate of deposit should be treated as an unamortized premium or discount, as appropriate, in Schedule RC-O, item 1.

A bank that purchases an equity-indexed certificate of deposit for investment purposes must either account for the embedded purchased equity call option separately from the certificate of deposit host contract or irrevocably elect to account for the hybrid instrument (the equity-indexed certificate of deposit) in its entirety at fair value.

- If the bank accounts for the purchased equity call option separately from the certificate of deposit, the fair value of this embedded derivative on the date of purchase must be deducted from the purchase price of the certificate, creating a discount on the deposit that must be accreted into income over the term of the deposit using the effective interest method. This accretion should be reported in the income statement in Schedule RI, item 1.c. The embedded equity derivative must be "marked to market" at least quarterly with any changes in its fair value recognized in earnings. These fair value changes should be reported consistently in Schedule RI in either item 5.l, "Other noninterest income," or item 7.d, "Other noninterest expense." The carrying value of the certificate of deposit host contract and the fair value of the embedded equity derivative may be combined and reported together as interest-bearing balances due from other depository institutions on the balance sheet in Schedule RC, item 1.b.

- If the bank elects to account for the equity-indexed certificate of deposit in its entirety at fair value, no discount is to be recorded on the certificate of deposit. Rather, the equity-indexed certificate of deposit must be “marked to market” at least quarterly, with changes in the instrument’s fair value reported in the income statement consistently in either item 5.l, "Other noninterest income," or item 7.d, "Other noninterest expense,” excluding interest income that is reported in Schedule RI, item 1.c.

Unless the bank elects to account for the equity-indexed certificate of deposit in its entirety at fair value, the notional amount of the embedded derivative must be reported in Schedule RC-L, item 12.d.(2), column C, and item 14, column C, and its fair value (which will always be positive or zero, but not negative) must be reported in Schedule RC-L, item 15.b.(1), column C. The embedded equity derivative in the equity-indexed certificate of deposit is a purchased option, which is subject to the agencies' risk-based capital standards unless the fair value election has been made.

Equity Method of Accounting: The equity method of accounting shall be used to account for:

(1) Investments in subsidiaries that have not been consolidated; associated companies; and corporate joint ventures, unincorporated joint ventures, and general partnerships over which the bank exercises significant influence; and

(2) Noncontrolling investments in:

(a) Limited partnerships; and

(b) Limited liability companies that maintain "specific ownership accounts" for each investor and are within the scope of ASC Subtopic 323-30, Investments-Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities (formerly EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Companies")

unless the investment in the limited partnership or limited liability company is so minor that the limited partner or investor may have virtually no influence over the operating and financial policies of the partnership or company. Consistent with guidance in ASC Subtopic 323-30, Investments-Equity Method and Joint Ventures – Partnerships, Joint Ventures, and Limited Liability Entities (formerly EITF Topic D-46, "Accounting for Limited Partnership Investments"), noncontrolling investments of more than 3 to 5 percent are considered to be more than minor.

The entities in which these investments have been made are collectively referred to as "investees."

Under the equity method, the carrying value of a bank's investment in an investee is originally recorded at cost but is adjusted periodically to record as income the bank's proportionate share of the investee's earnings or losses and decreased by the amount of cash dividends or similar distributions received from the investee. For purposes of these reports, the date through which the carrying value of the bank's investment in an investee has been adjusted should, to the extent practicable, match the report date of the Report of Condition, but in no case differ by more than 93 days from the report.

See also "subsidiaries."

Extinguishments of Liabilities: The accounting and reporting standards for extinguishments of liabilities are set forth in ASC Subtopic 405-20, Liabilities – Extinguishments of Liabilities (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"). Under ASC Subtopic 405-20, a bank should remove a previously recognized liability from its balance sheet if and only if the liability has been extinguished. A liability has been extinguished if either of the following conditions is met:

(1) The bank pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivering cash, other financial assets, goods, or services or the bank's reacquiring its outstanding debt.

(2) The bank is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Except for those unusual and infrequent gains and losses that qualify as extraordinary under the criteria in ASC Subtopic 225-20, Income Statement – Extraordinary and Unusual Items (formerly APB Opinion No. 30, "Reporting the Results of Operations"), banks should aggregate their gains and losses from the extinguishment of liabilities (debt), including losses resulting from the payment of prepayment penalties on borrowings such as Federal Home Loan Bank advances, and consistently report the net amount in item 7.d, "Other noninterest expense," of the income statement (Schedule RI). Only if a bank's debt extinguishments normally result in net gains over time should the bank consistently report its net gains (losses) in Schedule RI, item 5.l, "Other noninterest income."

Extinguishments of Liabilities (cont.):

In addition, under ASC Subtopic 470-50, Debt – Modifications and Extinguishments (formerly FASB EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments"), the accounting for the gain or loss on the modification or exchange of debt depends on whether the original and the new debt instruments are substantially different. If they are substantially different, the transaction is treated as an extinguishment of debt and the gain or loss on the modification or exchange is reported immediately in earnings as discussed in the preceding paragraph. If the original and new debt instruments are not substantially different, the gain or loss on the modification or replacement of the debt is deferred and recognized over time as an adjustment to the interest expense on the new borrowing. ASC Subtopic 470-50 provides guidance on how to determine whether the original and the new debt instruments are substantially different.

Extraordinary Items: Extraordinary items are material events and transactions that are (1) unusual and (2) infrequent. Both of those conditions must exist in order for an event or transaction to be reported as an extraordinary item.

To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of banks. An event or transaction that is beyond bank management's control is not automatically considered to be unusual.

To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent.

Only a limited number of events or transactions qualify for treatment as extraordinary items. Among these are losses which result directly from a major disaster such as an earthquake (except in areas where earthquakes are expected to recur in the foreseeable future), an expropriation, or a prohibition under a newly enacted law or regulation.

For further information, see ASC Subtopic 225-20, Income Statement – Extraordinary and Unusual Items (formerly APB Opinion No. 30, "Reporting the Results of Operations").

Fails: When a bank has sold an asset and, on settlement date, does not deliver the security or other asset and does not receive payment, a sales fail exists. When a bank has purchased a security or other asset and, on settlement date, does not receive the asset and does not pay for it, a purchase fail exists. Fails do not affect the way securities are reported in the Reports of Condition and Income.

Fair Value: ASC Topic 820, Fair Value Measurements and Disclosures (formerly FASB Statement No. 157, "Fair Value Measurements"), defines fair value and establishes a framework for measuring fair value. ASC Topic 820 should be applied when other accounting topics require or permit fair value measurements. For further information, refer to ASC Topic 820.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an "exit" price.

An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced liquidation or distressed sale.

ASC Topic 820 establishes a three level fair value hierarchy that prioritizes inputs used to measure fair value based on observability. The highest priority is given to Level 1 (observable, unadjusted) and the lowest priority to Level 3 (unobservable). The broad principles for the hierarchy follow.

<u>Fair Value (cont.):</u>

Level 1 fair value measurement inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that a bank has the ability to access at the measurement date. In addition, a Level 1 fair value measurement of a liability can also include the quoted price for an identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required.

Level 2 fair value measurement inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Depending on the specific factors related to an asset or a liability, certain adjustments to Level 2 inputs may be necessary to determine the fair value of the asset or liability. If those adjustments are significant to the asset or liability's fair value in its entirety, the adjustments may render the fair value measurement to a Level 3 measurement.

Level 3 fair value measurement inputs are unobservable inputs for the asset or liability. Although these inputs may not be readily observable in the market, the fair value measurement objective is, nonetheless, to develop an exit price for the asset or liability from the perspective of a market participant. Therefore, Level 3 fair value measurement inputs should reflect the bank's own assumptions about the assumptions that a market participant would use in pricing an asset or liability and should be based on the best information available in the circumstances.

Refer to ASC Topic 820 for additional fair value measurement guidance, including considerations related to holding large positions (blocks), the existence of multiple active markets, and the use of practical expedients.

<u>Measurement of Fair Values in Stressed Market Conditions</u> – The measurement of various assets and liabilities on the balance sheet – including trading assets and liabilities, available-for-sale securities, loans held for sale, assets and liabilities accounted for under the fair value option, and foreclosed assets – involves the use of fair values. During periods of market stress, the fair values of some financial instruments and nonfinancial assets may be difficult to determine. Institutions are reminded that, under such conditions, fair value measurements should be determined consistent with the objective of fair value set forth in ASC Topic 820.

ASC Topic 820 provides guidance on determining fair value when the volume and level of activity for an asset or liability have significantly decreased when compared with normal market activity for the asset or liability (or similar assets or liabilities). According to ASC Topic 820, if there has been such a significant decrease, transactions or quoted prices may not be determinative of fair value because, for example, there may be increased instances of transactions that are not orderly. In those circumstances, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with ASC Topic 820.

<u>Federal Funds Transactions:</u> For purposes of the Reports of Condition and Income, federal funds transactions involve the reporting bank's lending (federal funds sold) or borrowing (federal funds purchased) in domestic offices of <u>immediately available funds</u> under agreements or contracts that <u>have an original maturity of one business day or roll over under a continuing contract</u>. However, funds lent or borrowed in the form of securities resale or repurchase agreements, due bills, borrowings from the Discount and Credit Department of a Federal Reserve Bank, deposits with and advances from a Federal Home Loan Bank, and overnight loans for commercial and industrial purposes are excluded from federal funds. Transactions that are to be reported as federal funds transactions may be secured or unsecured or may involve an agreement to resell loans or other instruments that are not securities.

Federal Funds Transactions (cont.):

Immediately available funds are funds that the purchasing bank can either use or dispose of on the same business day that the transaction giving rise to the receipt or disposal of the funds is executed.

The borrowing and lending of immediately available funds has an original maturity of one business day if the funds borrowed on one business day are to be repaid or the transaction reversed on the next business day, that is, if immediately available funds borrowed today are to be repaid tomorrow (in tomorrow's immediately available funds). Such transactions include those made on a Friday to mature or be reversed the following Monday and those made on the last business day prior to a holiday (for either or both of the parties to the transaction) to mature or be reversed on the first business day following the holiday.

A continuing contract is a contract or agreement that remains in effect for more than one business day, but has no specified maturity and does not require advance notice of either party to terminate. Such contracts may also be known as rollovers or as open-ended agreements.

Federal funds may take the form of the following two types of transactions in domestic offices provided that the transactions meet the above criteria (i.e., immediately available funds with an original maturity of one business day or under a continuing contract):

(1) Unsecured loans (federal funds sold) or borrowings (federal funds purchased). (In some market usage, the term "fed funds" or "pure fed funds" is confined to unsecured loans of immediately available balances.)

(2) Purchases (sales) of financial assets (other than securities) under agreements to resell (repurchase) that have original maturities of one business day (or are under continuing contracts) and are in immediately available funds.

Any borrowing or lending of immediately available funds in domestic offices that has an original maturity of more than one business day, other than securities repurchase or resale agreements, is to be treated as a borrowing or as a loan, not as federal funds. Such transactions are sometimes referred to as "term federal funds."

Federally-Sponsored Lending Agency: A federally-sponsored lending agency is an agency or corporation that has been chartered, authorized, or organized as a result of federal legislation for the purpose of providing credit services to a designated sector of the economy. These agencies include Banks for Cooperatives, Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, Federal Intermediate Credit Banks, Federal Land Banks, the Federal National Mortgage Association, and the Student Loan Marketing Association.

Fees, Loan: See "loan fees."

<u>Foreclosed Assets:</u> The accounting and reporting standards for foreclosed assets are set forth in ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"), and ASC Topic 360, Property, Plant, and Equipment (formerly FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"). Subsequent to the issuance of Statement No. 144, AICPA Statement of Position (SOP) No. 92-3, "Accounting for Foreclosed Assets," was rescinded. Certain provisions of SOP 92-3 are not present in Statement No. 144, but the application of these provisions represents prevalent practice in the banking industry and is consistent with safe and sound banking practices and the accounting objectives set forth in Section 37(a) of the Federal Deposit Insurance Act. These provisions of SOP 92-3 have been incorporated into this Glossary entry, which banks must follow for purposes of preparing their Reports of Condition and Income.

A bank that receives from a borrower in full satisfaction of a loan either a receivables from third party, an equity interest in the borrower, or another type of asset (except a long-lived asset that will be sold) shall account for the asset received at its fair value at the time of the restructuring. When a bank receives a long-lived asset, such as real estate, from a borrower in full satisfaction of a loan, the long-lived asset is rebuttably presumed to be held for sale and the bank shall account for this asset at its fair value less cost to sell. This fair value (less cost to sell) becomes the "cost" of the foreclosed asset. The amount, if any, by which the recorded amount of the loan exceeds the fair value (less cost to sell) of the asset is a loss which must be charged to the allowance for loan and lease losses <u>at the time of foreclosure or repossession</u>. (The <u>recorded amount of the loan</u> is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus <u>recorded</u> accrued interest.)

If an asset is sold <u>shortly</u> after it is received in a foreclosure or repossession, it would generally be appropriate to substitute the value received in the sale (net of the cost to sell for long-lived assets that will be sold such as real estate) for the fair value (less cost to sell for long-lived assets that will be sold such as real estate) that had been estimated at the time of foreclosure or repossession. Any adjustments should be made to the loss charged against the allowance. In those cases where property is received in full satisfaction of an asset other than a loan (e.g., a debt security), the loss should be reported on the income statement in a manner consistent with the balance sheet classification of the asset satisfied.

An asset received in partial satisfaction of a loan should be accounted for as described above and the recorded amount of the loan should be reduced by the fair value (less cost to sell) of the asset at the time of foreclosure.

For purposes of these reports, foreclosed assets include loans where the bank, as creditor, has received physical possession of a borrower's assets, regardless of whether formal foreclosure proceedings take place. In such situations, the secured loan should be recategorized on the balance sheet in the asset category appropriate to the underlying collateral (e.g., as other real estate owned for real estate collateral) and accounted for as described above.

The amount of any senior debt (principal and accrued interest) to which foreclosed real estate is subject at the time of foreclosure must be reported as a liability in Schedule RC-M, item 5.b, "Other borrowings."

After foreclosure, each foreclosed real estate asset (including any real estate for which the bank receives physical possession, regardless of whether formal foreclosure proceedings take place) must be carried at the lower of (1) the fair value of the asset minus the estimated costs to sell the asset or (2) the cost of the asset (as defined in the preceding paragraphs). This determination must be made on an asset-by-asset basis. If the fair value of a foreclosed real estate asset minus the estimated costs to sell the asset is less than the asset's cost, the deficiency must be recognized as a valuation allowance against the asset which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) through charges or credits to expense for changes in the asset's fair value or estimated selling costs.

Foreclosed Assets (cont.):

If a foreclosed real estate asset is held for more than a short period of time, any declines in value after foreclosure and any gain or loss from the sale or disposition of the asset shall not be reported as a loan or lease loss or recovery and shall not be debited or credited to the allowance for loan and lease losses. Such additional declines in value and the gain or loss from the sale or disposition shall be reported net on the income statement in Schedule RI, item 5.j, “Net gains (losses) on sales of other real estate owned.”

Dispositions of Foreclosed Real Estate – The primary accounting guidance for sales of foreclosed real estate is ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FASB Statement No. 66, "Accounting for Sales of Real Estate"). This standard, which applies to all transactions in which the seller provides financing to the buyer of the real estate, establishes the following methods to account for dispositions of real estate. If a profit is involved in the sale of real estate, each method sets forth the manner in which the profit is to be recognized. Regardless of which method is used, however, any losses on the disposition of real estate should be recognized immediately.

Full Accrual Method – Under the full accrual method, the disposition is recorded as a sale. Any profit resulting from the sale is recognized in full and the asset resulting from the seller's financing of the transaction is reported as a loan. This method may be used when the following conditions have been met:

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

Guidelines for the minimum down payment that must be made in order for a transaction to qualify for the full accrual method are set forth in the Appendix A to ASC Subtopic 360-20. These vary from five percent to 25 percent of the property's sales value. These guideline percentages vary by type of property and are primarily based on the inherent risk assumed for the type and characteristics of the property. To meet the continuing investment criteria, the contractual loan payments must be sufficient to repay the loan over the customary loan term for the type of property involved. Such periods may range up to 30 years for loans on single family residential property.

Installment Method – Dispositions of foreclosed real estate that do not qualify for the full accrual method may qualify for the installment method. This method recognizes a sale and the corresponding loan. Any profits on the sale are only recognized as the bank receives payments from the purchaser/borrower. Interest income is recognized on an accrual basis, when appropriate.

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

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

Foreclosed Assets (cont.):

Cost Recovery Method – Dispositions of foreclosed real estate that do not qualify for either the full accrual or installment methods are sometimes accounted for using the cost recovery method. This method recognizes a sale and the corresponding loan, but all income recognition is deferred. Principal payments are applied as a reduction of the loan balance and interest increases the unrecognized gross profit. No profit or interest income is recognized until either the aggregate payments by the borrower exceed the recorded amount of the loan or a change to another accounting method is appropriate (e.g., installment method). Consequently, the loan is maintained in nonaccrual status while this method is being used.

Reduced-Profit Method – This method is used in certain situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full accrual method. The method recognizes a sale and the corresponding loan. However, like the installment method, any profit is apportioned over the life of the loan as payments are received. The method of apportionment differs from the installment method in that profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement.

Since sales with adequate down payments are generally not structured with inadequate loan amortization requirements, this method is seldom used in practice.

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

The preceding discussion represents a brief summary of the methods included in ASC Subtopic 360-20 for accounting for sales of real estate. Refer to ASC Subtopic 360-20 for a more complete description of the accounting principles that apply to sales of real estate, including the determination of the down payment percentage.

Foreign Banks: See "banks, U.S. and foreign."

Foreign Currency Transactions and Translation: Foreign currency transactions are transactions occurring in the ordinary course of business (e.g., purchases, sales, borrowings, and lendings) denominated in a currency other than the office's functional currency (as described below).

Foreign currency translation, on the other hand, is the process of translating financial statements from the foreign office's functional currency into the reporting currency. Such translation normally is performed only at reporting dates.

A functional currency is the currency of the primary economic environment in which an office operates. For most banks, the functional currency will be the U.S. dollar. However, if a bank has foreign offices, one or more foreign offices may have a functional currency other than the U.S. dollar.

Accounting for foreign currency transactions – A change in exchange rates between the functional currency and the currency in which a transaction is denominated will increase or decrease the amount of the functional currency expected to be received or paid. These increases or decreases in the expected functional currency cash flow are foreign currency transaction gains and losses and are to be included in the determination of the income of the period in which the transaction takes place, or if the transaction has not yet settled, the period in which the rate change takes place.

<u>Foreign Currency Transactions and Translation (cont.):</u>

Except for foreign currency derivatives and transactions described in the following section, banks should consistently report net gains (losses) from foreign currency transactions other than trading transactions in Schedule RI, item 5.l, "Other noninterest income," or item 7.d, "Other noninterest expense." Net gains (losses) from foreign currency trading transactions should be reported in Schedule RI, item 5.c, "Trading revenue."

<u>Foreign currency transaction gains or losses to be excluded from the determination of net income</u> – Gains and losses on the following foreign currency transactions shall not be included in "Noninterest income" or "Noninterest expense," but shall be reported in the same manner as translation adjustments (as described below):

(1) Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign office.

(2) Intercompany foreign currency transactions that are of a long-term investment nature (i.e., settlement is not planned or anticipated in the foreseeable future), when the parties to the transaction are consolidated, combined, or accounted for by the equity method in the bank's Reports of Condition and Income.

In addition, the entire change in the fair value of foreign-currency-denominated available-for-sale debt securities should not be included in “Realized gains (losses) on available-for-sale debt securities” (Schedule RI, item 6.b), but should be reported in Schedule RI-A, item 10, "Other comprehensive income." These fair value changes should be accumulated in the "Net unrealized holding gains (losses) on available-for-sale securities” component of "Accumulated other comprehensive income" in Schedule RC, item 26.b. However, if a decline in fair value of a foreign-currency-denominated available-for-sale debt security is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (Schedule RI, item 6.b).

<u>See</u> the Glossary entry for "derivative contracts" for information on the accounting and reporting for foreign currency derivatives.

<u>Accounting for foreign currency translation (applicable only to banks with foreign offices)</u> --The Reports of Condition and Income must be reported in U.S. dollars. Balances of foreign subsidiaries or branches of the reporting bank denominated in a functional currency other than U.S. dollars shall be converted to U.S. dollar equivalents and consolidated into the reporting bank's Reports of Condition and Income. The translation adjustments for each reporting period, determined utilizing the current rate method, should be reported in Schedule RI-A, item 10, "Other comprehensive income." Amounts accumulated in the "Cumulative foreign currency translation adjustments" component of "Accumulated other comprehensive income" in Schedule RC, item 26.b, will not be included in the bank's results of operations until such time as the foreign office is disposed of, when they will be used as an element to determine the gain or loss on disposition.

For further guidance, refer to ASC Topic 830, Foreign Currency Matters (formerly FASB Statement No. 52, "Foreign Currency Translation").

Foreign Debt Exchange Transactions: Foreign debt exchange transactions generally fall into three categories: (1) loan swaps, (2) debt/equity swaps, and (3) debt-for-development swaps. These transactions are to be reported in the Reports of Condition and Income in accordance with generally accepted accounting principles as summarized below. The accounting pronouncements mentioned below should be consulted for more detailed reporting guidance in these areas.

Generally accepted accounting principles require that these transactions be reported at their fair value. There is a significant amount of precedent in the accounting for exchange transactions to consider both the fair value of the consideration given up as well as the fair value of the assets received in arriving at the most informed valuation, especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. It is the responsibility of management to make the valuation considering all of the circumstances. Such valuations are subject to examiner review.

Among the factors to consider in determining fair values for foreign debt exchange transactions are:

(1) Similar transactions for cash;

(2) Estimated cash flows from the debt or equity instruments or other assets received;

(3) Market values, if any, of similar instruments; and

(4) Currency restrictions, if any, affecting payments on or sales of the debt or equity instruments, local currency, or other assets received, including where appropriate those affecting the repatriation of capital.

Losses arise from swap transactions when the fair value determined for the transaction is less than the recorded investment in the sovereign debt and other consideration paid, if any. Such losses should generally be charged to the allowance for loan and lease losses (or allocated transfer risk reserve, if appropriate) and must include any discounts from official exchange rates that are imposed by sovereign obligors as transaction fees. All other fees and transaction costs involved in such transactions must be charged to expense as incurred.

Loss recoveries or even gains might be indicated in a swap transaction as a result of the valuation process. However, due to the subjective nature of the valuation process, such loss recoveries or gains ordinarily should not be recorded until the debt or equity instruments, local currency, or other assets received in the exchange transaction are realized in unrestricted cash or cash equivalents.

Loan swaps – Foreign loan swaps, or debt/debt swaps, involve the exchange of one foreign loan for another. This type of transaction represents an exchange of monetary assets that must be reported at current fair value. Normally, when monetary assets are exchanged, with or without additional cash payments, and the parties have no remaining obligations to each other, the earnings process is complete.

Debt/equity swaps – The reporting treatment for this type of transaction is presented in ASC Subtopic 942-310, Financial Services-Depository and Lending – Receivables (formerly AICPA Practice Bulletin No. 4, "Accounting for Foreign Debt/Equity Swaps").

A foreign debt/equity swap represents an exchange of monetary for nonmonetary assets that must be measured at fair value. This type of swap is typically accomplished when holders of U.S. dollar-denominated sovereign debt agree to convert that debt into approved local equity investments. The holders are generally credited with local currency at the official exchange rate. A discount from the official exchange rate is often imposed as a transaction fee. The local currency is generally not

Foreign Debt Exchange Transactions (cont.):

available to the holders for any purposes other than approved equity investments. Restrictions may be placed on dividends on the equity investments and capital usually cannot be repatriated for several years.

In arriving at the fair value of the transaction, both the secondary market price of the debt given up and the fair value of the equity investment or assets received should be considered.

Debt-for-development swaps – In this type of exchange, sovereign debt held by a bank is generally purchased by a nonprofit organization or contributed to the nonprofit the nonprofit organization. When the sovereign debt is purchased by or donated to a nonprofit organization, the organization may enter into an agreement with the debtor country to cancel the debt in return for the country's commitment to provide local currency or other assets for use in connection with specific projects or programs in that country. Alternatively, a bank may exchange the sovereign debt with the country and receive local currency. In this alternative, the local currency will be donated or sold to the nonprofit organization for use in connection with specific projects or programs in that country.

These transactions, including amounts charged to expense as donations, must be reported at their fair values in accordance with generally accepted accounting principles applicable to foreign debt exchange transactions. This includes appropriate consideration of the market value of the instruments involved in the transaction and the fair value of any assets received, taking into account any restrictions that would limit the use of the assets. In debt-for-development swaps where a bank receives local currency in exchange for the sovereign loan it held and the local currency has no restrictions on its use and is freely convertible, it is generally appropriate for fair value to be determined by valuing the local currency received at its fair market exchange value.

Foreign Governments and Official Institutions: Foreign governments and official institutions are central, state, provincial, and local governments in foreign countries and their ministries, departments, and agencies. These include treasuries, ministries of finance, central banks, development banks, exchange control offices, stabilization funds, diplomatic establishments, fiscal agents, and nationalized banks and other banking institutions that are owned by central governments and that have as an important part of their function activities similar to those of a treasury, central bank, exchange control office, or stabilization fund. For purposes of these reports, other government-owned enterprises are not included.

Also included as foreign official institutions are international, regional, and treaty organizations, such as the International Monetary Fund, the International Bank for Reconstruction and Development (World Bank), the Bank for International Settlements, the Inter-American Development Bank, and the United Nations.

Foreign Office: For purposes of these reports, a foreign office of the reporting bank is a branch or consolidated subsidiary located in a foreign country; an Edge or Agreement subsidiary, including both its U.S. and its foreign offices; or an IBF. In addition, if the reporting bank is chartered and headquartered in the 50 states of the United States and the District of Columbia, a branch or consolidated subsidiary located in Puerto Rico or a U.S. territory or possession is a foreign office. Branches on U.S. military facilities wherever located are treated as domestic offices, not foreign offices.

Forward Contracts: See "derivative contracts."

Functional Currency: See "foreign currency transactions and translation."

Futures Contracts: See "derivative contracts."

Goodwill: See "purchase acquisition" in the entry for "business combinations."

Hypothecated Deposit: A hypothecated deposit is the aggregation of periodic payments on an installment contract received by a reporting institution in a state in which, under law, such payments are not immediately used to reduce the unpaid balance of the installment note, but are accumulated until the sum of the payments equals the entire amount of principal and interest on the contract, at which time the loan is considered paid in full. For purposes of these reports, hypothecated deposits are to be netted against the related loans.

Deposits that simply serve as collateral for loans are not considered hypothecated deposits for purposes of these reports.

See also "deposits."

IBF: See "International Banking Facility (IBF)."

Income Taxes: All banks, regardless of size, are required to report income taxes (federal, state and local, and foreign) in the Reports of Condition and Income on an accrual basis. Note that, in almost all cases, applicable income taxes as reported on the Report of Income will differ from amounts reported to taxing authorities. The applicable income tax expense or benefit that is reflected in the Report of Income should include both taxes currently paid or payable (or receivable) and deferred income taxes. The following discussion of income taxes is based on ASC Topic 740, Income Taxes (formerly FASB Statement No. 109, "Accounting for Income Taxes," and FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes”).

Applicable income taxes in the year-end Report of Income shall be the sum of the following:

(1) Taxes currently paid or payable (or receivable) for the year determined from the bank's federal, state, and local income tax returns for that year. Since the bank's tax returns will not normally be prepared until after the year-end Reports of Condition and Income have been completed, the bank must estimate the amount of the current income tax liability (or receivable) that will ultimately be reported on its tax returns. Estimation of this liability (or receivable) may involve consultation with the bank's tax advisers, a review of the previous year's tax returns, the identification of significant expected differences between items of income and expense reflected on the Report of Income and on the tax returns, and the identification of expected tax credits.)

and

(2) Deferred income tax expense or benefit measured as the change in the net deferred tax assets or liabilities for the period reported. Deferred tax liabilities and assets represent the amount by which taxes payable (or receivable) are expected to increase or decrease in the future as a result of "temporary differences" and net operating loss or tax credit carryforwards that exist at the reporting date.

The actual tax liability (or receivable) calculated on the bank's tax returns may differ from the estimate reported as currently payable or receivable on the year-end Report of Income. An amendment to the bank's year-end and subsequent Reports of Condition and Income may be appropriate if the difference is significant. Minor differences should be handled as accrual adjustments to applicable income taxes in Reports of Income during the year the differences are detected. The reporting of applicable income taxes in the Report of Income for report dates other than year-end is discussed below under "interim period applicable income taxes."

When determining the current and deferred income tax assets and liabilities to be reported in any period, a bank’s income tax calculation contains an inherent degree of uncertainty surrounding the realizability of the tax positions included in the calculation. The term “tax position” refers to a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected

Income Taxes (cont.):

in measuring current or deferred income tax assets and liabilities. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. For each tax position taken or expected to be taken in a tax return, a bank must evaluate whether the tax position is more likely than not, i.e., more than a 50 percent probability, to be sustained upon examination by the appropriate taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, a bank should presume that the taxing authority examining the position will have full knowledge of all relevant information. A bank's assessment of the technical merits of a tax position should reflect consideration of all relevant authoritative sources, e.g., tax legislation and statutes, legislative intent, regulations, rulings, and case law, and reflect the bank's determination of the applicability of these sources to the facts and circumstances of the tax position. A bank must evaluate each tax position without consideration of the possibility of an offset or aggregation with other positions. No tax benefit can be recorded for a tax position that fails to meet the more-likely-than-not recognition threshold.

Each tax position that meets the more-likely-than-not recognition threshold should be measured to determine the amount of benefit to recognize in the Reports of Condition and Income. The tax position is measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. When measuring the tax benefit, a bank must consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement using the facts, circumstances, and information available at the reporting date. A bank may not use the valuation allowance associated with any deferred tax asset as a substitute for measuring this tax benefit or as an offset to this amount.

If a bank's assessment of the merits of a tax position subsequently changes, the bank should adjust the amount of tax benefit it has recognized and accrue interest and penalties for any underpayment of taxes in accordance with the tax laws of each applicable jurisdiction. In this regard, a tax position that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent quarterly reporting period in which the threshold is met. A previously recognized tax position that no longer meets the more-likely-than-not recognition threshold should be derecognized in the first subsequent quarterly reporting period in which the threshold is no longer met.

Temporary differences result when events are recognized in one period on the bank's books but are recognized in another period on the bank's tax return. These differences result in amounts of income or expense being reported in the Report of Income in one period but in another period in the tax returns. There are two types of temporary differences. Deductible temporary differences reduce taxable income in future periods. Taxable temporary differences result in additional taxable income in future periods.

For example, a bank's provision for loan and lease losses is expensed for financial reporting purposes in one period. However, for some banks, this amount may not be deducted for tax purposes until the loans are actually charged off in a subsequent period. This deductible temporary difference "originates" when the provision for loan and lease losses is recorded in the financial statements and "turns around" or "reverses" when the loans are subsequently charged off, creating tax deductions. Other deductible temporary differences include writedowns of other real estate owned, the recognition of loan origination fees, and other postemployment benefits expense.

Depreciation can result in a taxable temporary difference if a bank uses the straight-line method to determine the amount of depreciation expense to be reported in the Report of Income but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this

Income Taxes (cont.):

Generally, an operating loss that occurs when loss carrybacks are not available (e.g., occurs in a year following periods of losses) becomes an operating loss carryforward. Banks may carry operating losses forward 20 years.

Tax credit carryforwards are tax credits which cannot be used for tax purposes in the current year, but which can be carried forward to reduce taxes payable in a future period.

Deferred tax assets are recognized for operating loss and tax credit carryforwards just as they are for deductible temporary differences. As a result, a bank can recognize the benefit of a net operating loss for tax purposes or a tax credit carryforward to the extent the bank determines that a valuation allowance is not considered necessary (i.e., if the realization of the benefit is more likely than not).

Applicable tax rate -- The income tax rate to be used in determining deferred tax assets and liabilities is the rate under current tax law that is expected to apply to taxable income in the periods in which the deferred tax assets or liabilities are expected to be realized or paid. If the bank's income level is such that graduated tax rates are a significant factor, then the bank shall use the average graduated tax rate applicable to the amount of estimated taxable income in the period in which the deferred tax asset or liability is expected to be realized or settled. When the tax law changes, banks shall determine the effect of the change, adjust the deferred tax asset or liability and include the effect of the change in Schedule RI, item 9, "Applicable income taxes (on item 8)."

Valuation allowance – A valuation allowance must be recorded, if needed, to reduce the amount of deferred tax assets to an amount that is more likely than not to be realized. Changes in the valuation allowance generally shall be reported in Schedule RI, item 9, "Applicable income taxes (on item 8)." The following discussion of the valuation allowance relates to the allowance, if any, included in the amount of net deferred tax assets or liabilities to be reported on the balance sheet (Schedule RC) and in Schedule RC-F, item 2, or Schedule RC-G, item 2. This discussion does not address the determination of the amount of deferred tax assets, if any, that is disallowed for regulatory capital purposes and reported in Schedule RC-R, item 9.b.

Banks must consider all available evidence, both positive and negative, in assessing the need for a valuation allowance. The future realization of deferred tax assets ultimately depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period. Four sources of taxable income may be available to realize the deferred tax assets:

(1) Taxable income in carryback years (which can be offset to recover taxes previously paid),

(2) Reversing taxable temporary differences,

(3) Future taxable income (exclusive of reversing temporary differences and carryforwards.

(4) Tax-planning strategies.

In general, positive evidence refers to the existence of one or more of the four sources of taxable income. To the extent evidence about one or more sources of income is sufficient to support a conclusion that a valuation allowance is not necessary (i.e., the bank can conclude that the deferred tax asset is more likely than not to be realized), other sources need not be considered. However, if a valuation allowance is needed, each source of income must be evaluated to determine the appropriate amount of the allowance needed.

Evidence used in determining the valuation allowance should be subject to objective verification. The weight given to evidence when both positive and negative evidence exist should be consistent with the extent to which it can be verified. Sources (1) and (2) listed above are more susceptible to objective verification and, therefore, may provide sufficient evidence regardless of future events.

Income Taxes (cont.):

The consideration of future taxable income (exclusive of reversing temporary differences and carryforwards) as a source for the realization of deferred tax assets will require subjective estimates and judgments about future events which may be less objectively verifiable.

Examples of negative evidence include:

- Cumulative losses in recent years.
- A history of operating loss or tax credit carryforwards expiring unused.
- Losses expected in early future years by a presently profitable bank.
- Unsettled circumstances that, if unfavorably resolved, would adversely affect future profit levels.
- A brief carryback or carryforward that would limit the ability to realize the deferred tax asset.

Examples of positive evidence include:

- A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss is an aberration rather than a continuing condition.
- Existing contracts that will generate significant income.
- An excess of appreciated asset value over the tax basis of an entity's net assets in an amount sufficient to realize the deferred tax asset.

When realization of a bank's deferred tax assets is dependent upon future taxable income, the reliability of a bank's projections is very important. The bank's record in achieving projected results under an actual operating plan will be a strong measure of this reliability. Other factors a bank should consider in evaluating evidence about its future profitability include but are not limited to current and expected economic conditions, concentrations of credit risk within specific industries and geographical areas, historical levels and trends in past due and nonaccrual assets, historical levels and trends in loan loss reserves, and the bank's interest rate sensitivity.

When strong negative evidence, such as the existence of cumulative losses, exists, it is extremely difficult for a bank to determine that no valuation allowance is needed. Positive evidence of significant quality and quantity would be required to counteract such negative evidence.

For purposes of determining the valuation allowance, a tax-planning strategy is a prudent and feasible action that would result in realization of deferred tax assets and that management ordinarily might not take, but would do so to prevent an operating loss or tax credit carryforward from expiring unused. For example, a bank could accelerate taxable income to utilize carryforwards by selling or securitizing loan portfolios, selling appreciated securities, or restructuring nonperforming assets. Actions that management would take in the normal course of business are not considered tax-planning strategies.

Significant expenses to implement the tax-planning strategy and any significant losses that would result from implementing the strategy shall be considered in determining any benefit to be realized from the tax-planning strategy. Also, banks should consider all possible consequences of any tax-planning strategies. For example, loans pledged as collateral would not be available for sale.

The determination of whether a valuation allowance is needed for deferred tax assets should be made for total deferred tax assets, not for deferred tax assets net of deferred tax liabilities. In addition, the evaluation should be made on a jurisdiction-by-jurisdiction basis. Separate analyses should be performed for amounts related to each taxing authority (e.g., federal, state, and local).

Deferred tax assets (net of the valuation allowance) and deferred tax liabilities related to a particular tax jurisdiction (e.g., federal, state, and local) may be offset against each other for reporting purposes. A resulting debit balance shall be included in "Other assets" and reported in Schedule RC-F, item 2. A

Income Taxes (cont.):

Purchase business combinations -- In purchase business combinations (as described in the Glossary entry for "business combinations"), banks shall recognize as a temporary difference the difference between the tax basis of acquired assets or liabilities and the amount of the purchase price allocated to the acquired assets and liabilities (with certain exceptions specified in ASC Topic 740). As a result, the acquired asset or liability shall be recorded gross and a deferred tax asset or liability shall be recorded for any resulting temporary difference.

In a purchase business combination, a deferred tax asset shall generally be recognized at the date of acquisition for deductible temporary differences and net operating loss and tax credit carryforwards of either company in the transaction, net of an appropriate valuation allowance. The determination of the valuation allowance should consider any provisions in the tax law that may restrict the use of an acquired company's carryforwards.

Subsequent recognition (i.e., by elimination of the valuation allowance) of the benefit of deductible temporary differences and net operating loss or tax credit carryforwards not recognized at the acquisition date will depend on the source of the benefit. If the valuation allowance relates to deductible temporary differences and carryforwards of the acquiring company established before the acquisition, then subsequent recognition is reported as a reduction of income tax expense. If the benefit is related to the acquired company's deductible temporary differences and carryforwards, then the benefit is subsequently recognized by first reducing any goodwill related to the acquisition, then by reducing all other noncurrent intangible assets related to the acquisition, and finally, by reducing income tax expense.

Alternative Minimum Tax – Any taxes a bank must pay in accordance with the alternative minimum tax (AMT) shall be included in the bank's current tax expense. Amounts of AMT paid can be carried forward in certain instances to reduce the bank's regular tax liability in future years. The bank may record a deferred tax asset for the amount of the AMT credit carryforward, which shall then be evaluated in the same manner as other deferred tax assets to determine whether a valuation allowance is needed.

Other tax effects – A bank may have transactions or items that are reportable in Schedule RI-A of the Report of Income such as "Restatements due to corrections of material accounting errors and changes in accounting principles," and, on the FFIEC 031 only, "Foreign currency translation adjustments" that are included in “Other comprehensive income.” These transactions or other items will enter into the determination of taxable income in some year (not necessarily the current year), but are not included in the pretax income reflected in Schedule RI of the Report of Income. They shall be reported in Schedule RI-A net of related income tax effects. These effects may increase or decrease the bank's total tax liability calculated on its tax returns for the current year or may be deferred to one or more future periods.

For further information, see ASC Topic 740.

Income Taxes (cont.):

The following table has been included to aid banks in calculating their "applicable income taxes" for purposes of the Reports of Condition and Income. The table includes the tax rates in effect for the years presented.

FEDERAL INCOME TAX RATES APPLICABLE TO BANKS

Year	First $25,000	Second $25,000	Third $25,000	Fourth $25,000	Over $100,000	Capital Gains	Alternative Minimum Tax
1993-2010	15%	15%	25%	34%	[1]	Regular tax rates	20%

Intangible Assets: See "business combinations" and the instruction to Report of Condition Schedule RC-M, item 2.

Interest-Bearing Account: See "deposits."

Interest Capitalization: See "capitalization of interest costs."

Interest Rate Swaps: See "derivative contracts."

Internal-Use Computer Software: Guidance on the accounting and reporting for the costs of internal-use computer software is set forth in ASC Subtopic 350-40, Intangibles-Goodwill and Other – Internal-Use Software (formerly AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"). A summary of this accounting guidance follows. For further information, see ASC Subtopic 350-40.

Internal-use computer software is software that meets both of the following characteristics:

(1) The software is acquired, internally developed, or modified solely to meet the bank's internal needs; and

(2) During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

ASC Subtopic 350-40 identifies three stages of development for internal-use software: the preliminary project stage, the application development stage, and the post-implementation/operation stage. The processes that occur during the preliminary project stage of software development are the conceptual formulation of alternatives, the evaluation of alternatives, the determination of the existence of needed technology, and the final selection of alternatives. The application development stage involves the design of the chosen path (including software configuration and software interfaces), coding, installation of software to hardware, and testing (including the parallel processing phase). Generally, training and application maintenance occur during the post-implementation/operation stage. Upgrades of and enhancements to existing internal-use software, i.e., modifications to software that result in additional functionality, also go through the three aforementioned stages of development.

[1] A 39% tax rate applies to taxable income from $100,001 to $335,000; a 34% tax rate applies to taxable income from $335,001 to $10,000,000; a tax rate of 35% applies to taxable income from $10,000,001 to $15,000,000; a tax rate of 38% applies to taxable income from $15,000,001 to $18,333,333; and a 35% tax rate applies to taxable income over $18,333,333.

Internal-Use Computer Software (cont.):

Computer software costs that are incurred in the preliminary project stage should be expensed as incurred.

Internal and external costs incurred to develop internal-use software during the application development stage should be capitalized. Capitalization of these costs should begin once (a) the preliminary project stage is completed and (b) management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended. Capitalization should cease no later than when a computer software project is substantially complete and ready for its intended use, i.e., after all substantial testing is completed. Capitalized internal-use software costs generally should be amortized on a straight-line basis over the estimated useful life of the software.

Only the following application development stage costs should be capitalized:

(1) External direct costs of materials and services consumed in developing or obtaining internal-use software;

(2) Payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and

(3) Interest costs incurred when developing internal-use software.

Costs to develop or obtain software that allows for access or conversion of old data by new systems also should be capitalized. Otherwise, data conversion costs should be expensed as incurred. General and administrative costs and overhead costs should not be capitalized as internal-use software costs.

During the post-implementation/operation stage, internal and external training costs and maintenance costs should be expensed as incurred.

Impairment of capitalized internal-use computer software costs should be recognized and measured in accordance with ASC Topic 360, Property, Plant, and Equipment (formerly FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets").

The costs of internally developed computer software to be sold, leased, or otherwise marketed as a separate product or process should be reported in accordance with ASC Subtopic 985-20, Software – Costs of Software to Be Sold, Leased or Marketed (formerly FASB Statement No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed"). If, after the development of internal-use software is completed, a bank decides to market the software, proceeds received from the license of the software, net of direct incremental marketing costs, should be applied against the carrying amount of the software.

International Banking Facility (IBF): General definition – An International Banking Facility (IBF) is a set of asset and liability accounts, segregated on the books and records of the establishing entity, which reflect international transactions. An IBF is established in accordance with the terms of Federal Reserve Regulation D and after appropriate notification to the Federal Reserve. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement corporation, or a U.S. branch or agency of a foreign bank pursuant to Federal Reserve Regulations D and Q. An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited, as specified in the paragraphs below, to non-U.S. residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity.

International Banking Facility (IBF) (cont.):

Permissible IBF assets include extensions of credit to the following:

(1) non-U.S. residents (including foreign branches of other U.S. banks);
(2) other IBFs; and
(3) U.S. and non-U.S. offices of the establishing entity.

Credit may be extended to non-U.S. nonbank residents only if the funds are used in their operations outside the United States. IBFs may extend credit in the form of a loan, deposit, placement, advance, security, or other similar asset.

Permissible IBF liabilities include (as specified in Federal Reserve Regulations D and Q) liabilities to non-U.S. nonbank residents only if such liabilities have a minimum maturity or notice period of at least two business days. IBF liabilities also may include overnight liabilities to:

(1) non-U.S. offices of other depository institutions and of Edge or Agreement corporations;
(2) non-U.S. offices of foreign banks;
(3) foreign governments and official institutions;
(4) other IBFs; and
(5) the establishing entity.

IBF liabilities may be issued in the form of deposits, borrowings, placements, and other similar instruments. However, IBFs are prohibited from issuing negotiable certificates of deposit, bankers acceptances, or other negotiable or bearer instruments.

Treatment of the reporting bank's IBFs in the Reports of Condition and Income – IBFs established by the reporting bank (i.e., by the bank or by its Edge or Agreement subsidiaries) are to be consolidated in the Reports of Condition and Income. In the consolidated balance sheet (Schedule RC) and income statement (Schedule RI), transactions between the IBFs of the reporting bank and between these IBFs and other offices of the bank are to be eliminated. (See the discussion of consolidation in the General Instructions section of this book.)

For purposes of these reports, the reporting bank's IBFs are to be treated as foreign offices of the bank. Thus, a bank with an IBF, even if it has no other foreign offices, must submit the Reports of Condition and Income applicable to banks with foreign offices (FFIEC 031). Similarly, the reporting bank's IBFs are to be treated as foreign offices where, in the supporting schedules, a distinction is made between foreign and domestic offices of the reporting bank.

Assets of the reporting bank's IBFs should be reported in the asset categories of the report by type of instrument and customer, as appropriate. For example, IBFs are to report their holdings of securities in Schedule RC, item 2, and in the appropriate items of Schedule RC-B; their holdings of loans that the IBF has the intent and ability to hold for the foreseeable future or until maturity or payoff (including loans of immediately available funds that have an original maturity of one business day or roll over under a continuing contract that are not securities resale agreements) in Schedule RC, item 4.b, and in the appropriate items of Schedule RC-C, part I; and securities purchased under agreements to resell in Schedule RC, item 3.b.

For purposes of these reports, all liabilities of the reporting bank's IBFs to outside parties are classified under four headings:

(1) Securities sold under agreements to repurchase, which are to be reported in Schedule RC, item 14.b;

International Banking Facility (IBF) (cont.):

(2) Borrowings of immediately available funds that have an original maturity of one business day or roll over under a continuing contract that are not securities repurchase agreements, which are to be reported in Schedule RC-M, item 5.b;

(3) Accrued liabilities, which are to be reported in Schedule RC, item 20; and

(4) All other liabilities, including deposits, placements, and borrowings, which are to be treated as deposit liabilities in foreign offices and reported in Schedule RC, item 13.b, and by customer detail in Schedule RC-E, part II.

In addition to being included in the appropriate items of the balance sheet, the total assets and total liabilities of the reporting bank's IBFs are to be reported separately in Schedule RC-I, Assets and Liabilities of IBFs, by banks with IBFs and other "foreign" offices. For a bank whose only foreign offices are IBFs, the total assets and liabilities of the reporting bank's IBFs are not reported separately in Schedule RC-I, but are derived from Schedule RC-H, Selected Balance Sheet Items for Domestic Offices.

Treatment of transactions with IBFs of other depository institutions – Transactions between the reporting bank and IBFs outside the scope of the reporting bank's consolidated Reports of Condition and Income are to be reported as transactions with depository institutions in the U.S., as appropriate. (Note, however, that only foreign offices of the reporting bank and the reporting bank's IBFs are permitted to have transactions with other IBFs.)

Interoffice Accounts: See "suspense accounts."

Investments in Common Stock of Unconsolidated Subsidiaries: See “equity method of accounting” and “subsidiaries.”

Joint Venture: See "subsidiaries."

Lease Accounting: A lease is an agreement that transfers the right to use land, buildings, or equipment for a specified period of time. This financing device is essentially an extension of credit evidenced by an obligation between a lessee and a lessor.

Standards for lease accounting are set forth in ASC Topic 840, Leases (formerly FASB Statement No. 13, "Accounting for Leases," as amended and interpreted).

Accounting with bank as lessee – Any lease entered into by a lessee bank that meets certain criteria (defined in the following paragraph) shall be accounted for as a property acquisition financed with a debt obligation. The property shall be amortized according to the bank's normal depreciation policy (except, if appropriate, the amortization period shall be the lease term) unless the lease involves land only. The interest expense portion of each lease payment shall be calculated to result in a constant rate of interest on the balance of the debt obligation. In the Report of Condition, the property "asset" is to be reported in Schedule RC, item 6, and the liability for capitalized leases in Schedule RC-M, item 5.b, "Other borrowings." In the Report of Income, the interest expense portion of the capital lease payments is to be reported in Schedule RI, item 2.c, "Interest on trading liabilities and other borrowed money," and the amortization expense on the asset is to be reported in Schedule RI, item 7.b, "Expenses of premises and fixed assets."

If any one of the following criteria is met, a lease must be accounted for as a capital lease:

(1) ownership of the property is transferred to the lessee at the end of the lease term, or

(2) the lease contains a bargain purchase option, or

<u>Lease Accounting (cont.):</u>

(3) the lease term represents at least 75 percent of the estimated economic life of the leased property, or

(4) the present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the leased property to the lessor at the inception of the lease less any related investment tax credit retained by and expected to be realized by the lessor.

If none of the above criteria is met, the lease should be accounted for as an <u>operating lease</u>. Normally, rental payments should be charged to expense over the term of the operating lease as they become payable.

NOTE: If a lease involves land only, the lease must be capitalized if either of the first two criteria above is met. Where a lease that involves land <u>and</u> building meets either of these two criteria, the land and building must be separately capitalized by the lessee. The accounting for a lease involving land and building that meets neither of the first two criteria should conform to the standards prescribed by ASC Topic 840.

<u>Accounting for sales with leasebacks</u> – Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. If a bank sells premises or fixed assets and leases back the property, the lease shall be treated as a capital lease if it meets any one of the four criteria above for capitalization. Otherwise, the lease shall be accounted for as an operating lease.

As a general rule, the bank shall defer any gain resulting from the sale. For capital leases, this deferred gain is amortized in proportion to the depreciation taken on the leased asset. For operating leases, the deferred gain is amortized in proportion to the rental payments the bank will make over the lease term. The unamortized deferred gain is to be reported in Schedule RC-G, item 4, "Other" liabilities. (Exceptions to the general rule on deferral that permit full or partial recognition of a gain at the time of the sale may occur if the leaseback covers less than substantially all of the property that was sold or if the total gain exceeds the minimum lease payments.)

If the fair value of the property at the time of the sale is less than the book value of the property, the difference between these two amounts shall be recognized as a loss immediately. In this case, if the sales price is less than the fair value of the property, the additional loss shall be deferred since it is in substance a prepayment of rent. Similarly, if the fair value of the property sold is greater than its book value, any loss on the sale shall also be deferred. Deferred losses shall be amortized in the same manner as deferred gains as described above.

For further information, see ASC Subtopic 840-40, Leases – Sale-Leaseback Transactions (formerly FASB Statement No. 28, "Accounting for Sales with Leasebacks").

<u>Accounting with bank as lessor</u> – Unless a long-term creditor is also involved in the transaction, a lease entered into by a lessor bank that meets one of the four criteria above for a capital lease plus two additional criteria (as defined below) shall be treated as a <u>direct financing lease</u>. The unearned income (minimum lease payments plus estimated residual value plus initial direct costs less the cost of the leased property) shall be amortized to income over the lease term in a manner which produces a constant rate of return on the net investment (minimum lease payments plus estimated residual value plus initial direct costs less unearned income). Other methods of income recognition may be used if the results are not materially different.

The following two additional criteria must be met for a lease to be classified as a direct financing lease:

(1) Collectability of the minimum lease payments is reasonably predictable.

(2) No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

Loan (cont.):

(8) loans arising out of the purchase of assets (other than securities) under resale agreements with a maturity of more than one business day if the agreement requires the bank to resell the identical asset purchased; and

(9) participations (acquired or held) in a single loan or in a pool of loans or receivables (see the discussion of loan participations in the Glossary entry for "transfers of financial assets").

Loan assets held for trading are to be reported in Schedule RC, item 5, "Trading assets."

See also "loan secured by real estate," "overdraft," and "transfers of financial assets."

Loan Fees: The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in ASC Subtopic 310-20, Receivables – Nonrefundable Fees and Other Costs (formerly FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases"), a summary of which follows. The statement applies to all types of loans as well as to debt securities (but not to loans or debt securities carried at fair value if the changes in fair value are included in earnings) and to all types of lenders. For further information, see ASC Subtopic 310-20.

A bank may acquire a loan by originating the loan (lending) or by acquiring a loan from a party other than the borrower (purchasing). Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, syndicating loans, and leasing activities are all considered "lending activities." Nonrefundable loan fees paid by the borrower to the lender may have many different names, such as origination fees, points, placement fees, commitment fees, application fees, management fees, restructuring fees, and syndication fees, but in this Glossary entry, they are referred to as loan origination fees, commitment fees, or syndication fees.

ASC Subtopic 310-20 applies to both a lender and a purchaser, and should be applied to individual loan contracts. Aggregation of similar loans for purposes of recognizing net fees or costs and purchase premiums or discounts is permitted under certain circumstances specified in ASC Subtopic 310-20 or if the result does not differ materially from the amount that would have been recognized on an individual loan-by-loan basis. In general, the statement specifies that:

(1) Loan origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield (interest income). Once a bank adopts ASC Subtopic 310-20, recognizing a portion of loan fees as revenue to offset all or part of origination costs in the reporting period in which a loan is originated is no longer acceptable.

(2) Certain direct loan origination costs specified in the Statement should be deferred and recognized over the life of the related loan as a reduction of the loan's yield. Loan origination fees and related direct loan origination costs for a given loan should be offset and only the net amount deferred and amortized.

(3) Direct loan origination costs should be offset against related commitment fees and the net amounts deferred except for: (a) commitment fees (net of costs) where the likelihood of exercise of the commitment is remote, which generally should be recognized as service fee income on a straight line basis over the loan commitment period, and (b) retrospectively determined fees, which are recognized as service fee income on the date as of which the amount of the fee is determined. All other commitment fees (net of costs) shall be deferred over the entire commitment period and recognized as an adjustment of yield over the related loan's life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

Loan Fees (cont.):

(4) Loan syndication fees should be recognized by the bank managing a loan syndication (the syndicator) when the syndication is complete unless a portion of the syndication loan is retained. If the yield on the portion of the loan retained by the syndicator is less than the average yield to the other syndication participants after considering the fees passed through by the syndicator, the syndicator should defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.

(5) Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan. However, if the bank holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the bank may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. Once a bank adopts ASC Subtopic 310-20, the practice of recognizing fees over the estimated average life of a group of loans is no longer acceptable.

(6) A refinanced or restructured loan, other than a troubled debt restructuring, should be accounted for as a new loan if the terms of the new loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan. Any unamortized net fees or costs and any prepayment penalties from the original loan should be recognized in interest income when the new loan is granted. If the refinancing or restructuring does not meet these conditions or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties should be carried forward as a part of the net investment in the new loan. The investment in the new loan should consist of the remaining net investment in the original loan, any additional amounts loaned, any fees received, and direct loan origination costs associated with the transaction. In a troubled debt restructuring involving a modification of terms, fees received should be applied as a reduction of the recorded investment in the loan, and all related costs, including direct loan origination costs, should be charged to expense as incurred. (See the Glossary entry for "troubled debt restructurings" for further guidance.)

(7) Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about realization of loan principal or interest.

Direct loan origination costs of a completed loan are defined to include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that particular loan and (b) certain costs directly related to specified activities performed by the lender for that particular loan.[1] Incremental direct costs are costs to originate a loan that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender had that lending transaction not occurred. The specified activities performed by the lender are evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that particular loan and other costs related to those activities that would not have been incurred but for that particular loan.

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[1] For purposes of these reports, a bank which deems its costs for these lending activities not to be material and which need not maintain records on a loan-by-loan basis for other purposes may expense such costs as incurred.

Loan Fees (cont.):

All other lending-related costs, whether or not incremental, should be charged to expense as incurred, including costs related to activities performed by the lender for advertising, identifying potential borrowers, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Employees' compensation and fringe benefits related to these activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Net unamortized loan fees represent an adjustment of the loan yield, and shall be reported in the same manner as unearned income on loans, i.e., deducted from the related loan balances (to the extent possible) or deducted from total loans in "Any unearned income on loans reflected in items 1-9 above" in Schedule RC-C, part I. Net unamortized direct loan origination costs shall be added to the related loan balances in Schedule RC-C, part I. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported under the appropriate subitem of item 1, "Interest income," in Schedule RI. Other fees, such as (a) commitment fees that are recognized during the commitment period or included in income when the commitment expires (i.e., fees retrospectively determined and fees for commitments where exercise is remote) and (b) syndication fees that are not deferred, should be reported as "Other noninterest income" on Schedule RI.

Loan Impairment: The accounting standard for impaired loans is ASC Topic 310, Receivables (formerly FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," as amended). For further information, refer to ASC Topic 310.

Each institution is responsible for maintaining an allowance for loan and lease losses (allowance) at a level that is appropriate to cover estimated credit losses in its entire portfolio of loans and leases held for investment, i.e., loans and leases that the bank has the intent and ability to hold for the foreseeable future or until maturity or payoff. ASC Topic 310 sets forth measurement methods for estimating the portion of the overall allowance for loan and lease losses attributable to individually impaired loans. For the remainder of the portfolio, an appropriate allowance must be maintained in accordance with ASC Subtopic 450-20, Contingencies – Loss Contingencies (formerly FASB Statement No. 5, “Accounting for Contingencies”). For comprehensive guidance on the maintenance of an appropriate allowance, banks should refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses dated December 13, 2006, and the Glossary entry for “allowance for loan and lease losses." National banks should also refer to the Office of the Comptroller of the Currency's Handbook for National Bank Examiners discussing the allowance for loan and lease losses.

In general, loans are impaired under ASC Topic 310 when, based on current information and events, it is probable that an institution will be unable to collect all amounts due (i.e., both principal and interest) according to the contractual terms of the original loan agreement. An institution should apply its normal loan review procedures when identifying loans to be individually evaluated for impairment under ASC Topic 310. When an individually evaluated loan is deemed impaired under ASC Topic 310, an institution should choose to measure impairment using (1) the present value of expected future cash flows discounted at the loan’s effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan), (2) the loan’s observable market price, or (3) the fair value of the collateral. An institution may choose the appropriate ASC Topic 310 measurement method on a loan-by-loan basis for an individually impaired loan, except for an impaired collateral dependent loan. As discussed in the following paragraph, the agencies require impairment of a collateral dependent loan to be measured using the fair value of collateral method. A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. A creditor should consider estimated costs to sell, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay

Loan Impairment (cont.):

or otherwise satisfy the loan. If the measure of an impaired loan is less than the recorded investment in the loan, an impairment should be recognized by creating an allowance for estimated credit losses for the impaired loan or by adjusting an existing allowance with a corresponding charge or credit to "Provision for loan and lease losses."

For purposes of the Reports of Condition and Income, impairment of a collateral dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded investment in an impaired collateral dependent loan (including recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible should be promptly charged off against the allowance for loan and lease losses.

An institution should not provide an additional allowance for estimated credit losses on an individually impaired loan over and above what is specified by ASC Topic 310. The allowance established under ASC Topic 310 should take into consideration all available information existing as of the Call Report date that indicates that it is probable that a loan has been impaired. All available information would include existing environmental factors such as industry, geographical, economic, and political factors that affect collectibility.

ASC Topic 310 also addresses the accounting by creditors for all loans that are restructured in troubled debt restructurings involving a modification of terms, except loans that are measured at fair value or the lower of cost or fair value. According to ASC Topic 310, all loans restructured in troubled debt restructurings are impaired loans. For guidance on troubled debt restructurings, see the Glossary entry for "troubled debt restructurings."

As with all other loans, all impaired loans should be reported as past due or nonaccrual loans in Schedule RC-N in accordance with the schedule's instructions. A loan identified as impaired is one for which it is probable that the institution will be unable to collect all principal and interest amounts due according to the contractual terms of the original loan agreement. Therefore, a loan that is not already in nonaccrual status when it is first identified as impaired will normally meet the criteria for placement in nonaccrual status at that time. Exceptions may arise when a loan not previously in nonaccrual status is identified as impaired because its terms have been modified in a troubled debt restructuring, but the borrower's sustained historical repayment performance for a reasonable time prior to the restructuring is consistent with the modified terms of the loan and the loan is reasonably assured of repayment (of principal and interest) and of performance in accordance with its modified terms. This determination must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Exceptions may also arise for those purchased impaired loans for which the criteria for accrual of income under the interest method are met as specified in ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"). Any cash payments received on impaired loans in nonaccrual status should be reported in accordance with the criteria for the cash basis recognition of income in the Glossary entry for "nonaccrual status." For further guidance, see the Glossary entries for "nonaccrual status" and "purchased impaired loans and debt securities."

Loan Secured by Real Estate: For purposes of these reports, a loan secured by real estate is a loan that, at origination, is secured wholly or substantially by a lien or liens on real property for which the lien or liens are central to the extension of the credit – that is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien or liens on real property. To be considered wholly or substantially secured by a lien or liens on real property, the estimated value of the real estate collateral at origination (after deducting any more senior liens held by others) must be greater than 50 percent of the principal amount of the loan at origination.[1]

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[1] Banks should apply this revised definition of "loan secured by real estate" prospectively beginning April 1, 2009. Loans reported on or before March 31, 2009, as loans secured by real estate need not be reevaluated and, if appropriate, recategorized into other loan categories on Schedule RC-C, part I, Loans and Leases.

Loan Secured by Real Estate (cont.):

A loan satisfying the criteria above, except a loan to a state or political subdivision in the U.S., is to be reported as a loan secured by real estate in Schedule RC-C, part I, item 1, and related items in the Reports of Condition and Income, (1) regardless of whether the loan is secured by a first or a junior lien; (2) regardless of whether the loan was originated by the reporting bank or purchased from others and, if originated by the reporting bank, regardless of the department within the bank or bank subsidiary that made the loan; (3) regardless of how the loan is categorized in the bank's records; (4) and regardless of the purpose of the financing. Only in a transaction where a lien or liens on real property (with an estimated collateral value greater than 50 percent of the loan's principal amount at origination) have been taken as collateral solely through an abundance of caution and where the loan terms as a consequence have not been made more favorable than they would have been in the absence of the lien or liens, would the loan not be considered a loan secured by real estate for purposes of the Reports of Condition and Income. In addition, when a loan is partially secured by a lien or liens on real property, but the estimated value of the real estate collateral at origination (after deducting any more senior liens held by others) is 50 percent or less of the principal amount of the loan at origination, the loan should not be categorized as a loan secured by real estate. Instead, the loan should be reported in one of the other loan categories used in these reports based on the purpose of the loan.

The following are examples of the application of the preceding guidance:

(1) A bank loans $700,000 to a dental group to construct and equip a building that will be used as its dental office. The loan will be secured by both the real estate and the dental equipment. At origination, the estimated values of the building, upon completion, and the equipment are $400,000 and $350,000, respectively. The loan should be reported as a loan secured by real estate in Schedule RC-C, part I, item 1.a.(2), "Other construction loans and all land development and other land loans." In contrast, if the estimated values of the building and equipment at origination were $340,000 and $410,000, respectively, the loan should not be reported as a loan secured by real estate. Instead, the loan should be reported in Schedule RC-C, part I, item 4, "Commercial and industrial loans."

(2) A bank grants a $25,000 line of credit and a $125,000 term loan to a commercial borrower for working capital purposes on the same date. The loans will be cross-collateralized by equipment with an estimated value of $40,000 and a third lien on the borrower's residence, which has an estimated value of $140,000 and first and second liens with unpaid balances payable to other lenders totaling $126,000. The two loans should be considered together to determine whether they are secured by real estate. Because the estimated equity in the real estate collateral available to the bank is $14,000, the two cross-collateralized loans for $150,000 should not be reported as loans secured by real estate. Instead, the loans should be reported in Schedule RC-C, part I, item 4, "Commercial and industrial loans."

(3) A bank grants a $50,000 working capital loan and takes a first lien on a vacant commercial building lot as collateral. The estimated value of the lot is $30,000. The loan should be reported as a loan secured by real estate in Schedule RC-C, part I, item 1.a.(2), "Other construction loans and all land development and other land loans," unless the lien has been taken as collateral solely through an abundance of caution and where the loan terms as a consequence have not been made more favorable than they would have been in the absence of the lien.

(4) A bank grants a $10,000 home equity line of credit secured by a junior lien on a 1-4 family residential property. The bank also has a loan to the same borrower that is secured by a first lien on the same 1-4 family residential property and has an unpaid principal balance of $71,000. There are no intervening liens and the line of credit will be used for household, family, and other personal expenditures. The estimated value of the residential property at the origination of the home equity line of credit is $75,000. Consistent with the risk-based capital treatment of these loans, the two loans should be considered together to determine whether the home equity line of credit should be

Loan Secured by Real Estate (cont.):

reported as a loan secured by real estate. Because the value of the collateral is greater than 50 percent of the first lien balance plus the amount of the home equity line of credit, loans extended under the line of credit should be reported as loans secured by real estate in Schedule RC-C, part I, item 1.c.(1), "Revolving, open-end loans secured by 1-4 family residential properties and extended under lines of credit." In contrast, if a creditor other than the bank holds the first lien on the borrower's property, the estimated value of the collateral to the bank for the home equity line of credit would have been $4,000 ($75,000 less the $71,000 first lien held by the other creditor), which is 50 percent or less of the amount of the line of credit at origination. In this case, the bank should not report loans extended under the line of credit as loans secured by real estate in Schedule RC-C, part I, item 1. Rather, the loans should be reported as "Loans to individuals for household, family, and other personal expenditures" in Schedule RC-C, part I, item 6.b, "Other revolving credit plans."

Loss Contingencies: A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. An estimated loss (or expense) from a loss contingency (for example, pending or threatened litigation) must be accrued by a charge to income if it is probable that an asset has been impaired or a liability incurred as of the report date and the amount of the loss can be reasonably estimated.

A contingency that might result in a gain, for example, the filing of an insurance claim, shall not be recognized as income prior to realization.

For further information, see ASC Subtopic 450-20, Contingencies – Loss Contingencies (formerly FASB Statement No. 5, "Accounting for Contingencies").

Majority-Owned Subsidiary: See "subsidiaries."

Mandatory Convertible Debt: Mandatory convertible debt is a subordinated note or debenture with a maturity of 12 years or less that obligates the holder to take the common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal by a date at or before the maturity date of the debt instrument (so-called "equity contract notes").

Mergers: See "business combinations."

Money Market Deposit Account (MMDA): See "deposits."

Nonaccrual Status: This entry covers, for purposes of these reports, the criteria for placing assets in nonaccrual status (presented in the general rule below) and related exceptions, the reversal of previously accrued but uncollected interest, the treatment of cash payments received on nonaccrual assets and the criteria for cash basis income recognition, the restoration of a nonaccrual asset to accrual status, and the treatment of multiple extensions of credit to one borrower.

General rule – Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.

An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

For purposes of applying the third test for nonaccrual status listed above, the date on which an asset reaches nonaccrual status is determined by its contractual terms. If the principal or interest on an asset becomes due and unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due and it should remain in nonaccrual status until it meets the criteria for restoration to accrual status described below.

Any state statute, regulation, or rule that imposes more stringent standards for nonaccrual of interest takes precedence over this instruction.

<u>Nonaccrual Status (cont.):</u>

<u>Exceptions to the general rule</u> – In the following situations, an asset need not be placed in nonaccrual status:

(1) The criteria for accrual of income under the interest method specified in ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"), are met for a purchased impaired loan or debt security accounted for in accordance with that Subtopic, regardless of whether the loan or debt security had been maintained in nonaccrual status by its seller. For further information, see the Glossary entry for "purchased impaired loans and debt securities."

(2) The criteria for amortization (i.e., accretion of discount) specified in former AICPA Practice Bulletin No. 6, "Amortization of Discounts on Certain Acquired Loans," are met with respect to a loan or other debt instrument accounted for in accordance with that Practice Bulletin that was acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party (such as another institution or the receiver of a failed institution), including those that the seller had maintained in nonaccrual status.

(3) The asset upon which principal or interest is due and unpaid for 90 days or more is a consumer loan (as defined for Schedule RC-C, part I, item 6, "Loans to individuals for household, family, and other personal expenditures") or a loan secured by a 1-to-4 family residential property (as defined for Schedule RC-C, part I, item 1.c, Loans "Secured by 1-4 family residential properties"). Nevertheless, such loans should be subject to other alternative methods of evaluation to assure that the bank's net income is not materially overstated. However, to the extent that the bank has elected to carry such a loan in nonaccrual status on its books, the loan must be reported as nonaccrual in Schedule RC-N.

<u>Treatment of previously accrued interest</u> – The reversal of previously accrued but uncollected interest applicable to any asset placed in nonaccrual status should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes a reversal of <u>all</u> previously accrued but uncollected interest applicable to assets placed in a nonaccrual status against appropriate income and balance sheet accounts.

For example, one acceptable method of accounting for such uncollected interest on a loan placed in nonaccrual status is (1) to reverse <u>all</u> of the unpaid interest by crediting the "accrued interest receivable" account on the balance sheet, (2) to reverse the uncollected interest that has been accrued during the calendar year-to-date by debiting the appropriate "interest and fee income on loans" account on the income statement, and (3) to reverse any uncollected interest that had been accrued during previous calendar years by debiting the "allowance for loan and lease losses" account on the balance sheet. The use of this method presumes that bank management's additions to the allowance through charges to the "provision for loan and lease losses" on the income statement have been based on an evaluation of the collectability of the loan and lease portfolios <u>and</u> the "accrued interest receivable" account.

<u>Treatment of cash payments and criteria for the cash basis recognition of income</u> – When doubt exists as to the collectability of the remaining recorded investment in an asset in nonaccrual status, any payments received must be applied to reduce the recorded investment in the asset to the extent necessary to eliminate such doubt. Placing an asset in nonaccrual status does <u>not</u>, in and of itself, require a charge-off, in whole or in part, of the asset's recorded investment. However, any identified losses must be charged off.

Nonaccrual Status (cont.):

While an asset is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining recorded investment in the asset (i.e., after charge-off of identified losses, if any) is deemed to be fully collectible.[3] A bank's determination as to the ultimate collectability of the asset's remaining recorded investment must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

When recognition of interest income on a cash basis is appropriate, it should be handled in accordance with generally accepted accounting principles. One acceptable accounting practice involves allocating contractual interest payments among interest income, reduction of the recorded investment in the asset, and recovery of prior charge-offs. If this method is used, the amount of income that is recognized would be equal to that which would have been accrued on the asset's remaining recorded investment at the contractual rate. A bank may also choose to account for the contractual interest in its entirety either as income, reduction of the recorded investment in the asset, or recovery of prior charge-offs, depending on the condition of the asset, consistent with its accounting policies for other financial reporting purposes.

Restoration to accrual status – As a general rule, a nonaccrual asset may be restored to accrual status when (1) none of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest, or (2) when it otherwise becomes well secured and in the process of collection. If any interest payments received while the asset was in nonaccrual status were applied to reduce the recorded investment in the asset, as discussed in the preceding section of this entry, the application of these payments to the asset's recorded investment should not be reversed (and interest income should not be credited) when the asset is returned to accrual status.

For purposes of meeting the first test, the bank must have received repayment of the past due principal and interest unless, as discussed below, (1) the asset has been formally restructured and qualifies for accrual status, (2) the asset is a purchased impaired loan or debt security accounted for in accordance with ASC Subtopic 310-30 and it meets the criteria for accrual of income under the interest method specified therein, (3) the asset has been acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party, is accounted for in accordance with former AICPA Practice Bulletin No. 6, and meets the criteria for amortization (i.e., accretion of discount) specified therein, or (4) the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments on a loan that is past due and in nonaccrual status, even though the loan has not been brought fully current, and the following two criteria are met. These criteria are, first, that all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period and, second, that there is a sustained period of repayment performance (generally a minimum of six months) by the borrower in accordance with the contractual terms involving payments of cash or cash equivalents. A loan that meets these two criteria may be restored to accrual status but must continue to be disclosed as past due in Schedule RC-N until it has been brought fully current or until it later must be placed in nonaccrual status.

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[3] An asset in nonaccrual status that is subject to the cost recovery method required by former AICPA Practice Bulletin No. 6 or ASC Subtopic 325-40, Investments-Other – Beneficial Interests in Securitized Financial Assets (formerly Emerging Issues Task Force Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets"), should follow that method for reporting purposes. In addition, when a purchased impaired loan or debt security that is accounted for in accordance with ASC Subtopic 310-30 has been placed on nonaccrual status, the cost recovery method should be used, when appropriate.

Nonaccrual Status (cont.):

A loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment (of principal and interest) and of performance according to its modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the asset are supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured asset must remain in nonaccrual status. The evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan or other debt instrument is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. (In returning the asset to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account.) Such a restructuring must improve the collectability of the loan or other debt instrument in accordance with a reasonable repayment schedule and does not relieve the bank from the responsibility to promptly charge off all identified losses.

A formal restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes. The first or "A" note represents the portion of the original loan principal amount that is expected to be fully collected along with contractual interest. The second or "B" note represents the portion of the original loan that has been charged off and, because it is not reflected as an asset and is unlikely to be collected, could be viewed as a contingent receivable. The "A" note may be returned to accrual status provided the conditions in the preceding paragraph are met and: (1) there is economic substance to the restructuring and it qualifies as a troubled debt restructuring under generally accepted accounting principles, (2) the portion of the original loan represented by the "B" note has been charged off before or at the time of the restructuring, and (3) the "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.

Until the restructured asset is restored to accrual status, if ever, cash payments received must be treated in accordance with the criteria stated above in the preceding section of this entry. In addition, after a formal restructuring, if a restructured asset that has been returned to accrual status later meets the criteria for placement in nonaccrual status as a result of past due status based on its modified terms or for any other reasons, the asset must be placed in nonaccrual status.

For further information on formally restructured assets, see the Glossary entry for "troubled debt restructurings."

Treatment of multiple extensions of credit to one borrower – As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectability and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all other extensions of credit to that borrower in nonaccrual status. When a bank has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets the criteria for nonaccrual status, the bank should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

Noninterest-Bearing Account: See "deposits."

Nontransaction Account: See "deposits."

NOW Account: See "deposits."

Offsetting: Offsetting is the reporting of assets and liabilities on a net basis in the balance sheet. Banks are permitted to offset assets and liabilities recognized in the Report of Condition when a "right of setoff" exists. Under ASC Subtopic 210-20, Balance Sheet – Offsetting (formerly FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts"), a right of setoff exists when all of the following conditions are met:

(1) Each of two parties owes the other determinable amounts. Thus, only bilateral netting is permitted.

(2) The reporting party has the right to set off the amount owed with the amount owed by the other party.

(3) The reporting party intends to set off. This condition does not have to be met for fair value amounts recognized for conditional or exchange contracts that have been executed with the same counterparty under a master netting arrangement.

(4) The right of setoff is enforceable at law. Legal constraints should be considered to determine whether the right of setoff is enforceable. Accordingly, the right of setoff should be upheld in bankruptcy (or receivership). Offsetting is appropriate only if the available evidence, both positive and negative, indicates that there is reasonable assurance that the right of setoff would be upheld in bankruptcy (or receivership).

According to ASC Subtopic 210-20, for forward, interest rate swap, currency swap, option, and other conditional and exchange contracts, a master netting arrangement exists if the reporting bank has multiple contracts, whether for the same type of conditional or exchange contract or for different types of contracts, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default or termination of any one contract.

Offsetting the assets and liabilities recognized for conditional or exchange contracts outstanding with a single counterparty results in the net position between the two counterparties being reported as an asset or a liability in the Report of Condition. The reporting entity's choice to offset or not to offset assets and liabilities recognized for conditional or exchange contracts must be applied consistently.

Offsetting of assets and liabilities is also permitted by other accounting pronouncements identified in ASC Subtopic 210-20. These pronouncements apply to such items as leveraged leases, pension plan and other postretirement benefit plan assets and liabilities, and deferred tax assets and liabilities. In addition, ASC Subtopic 210-20, Balance Sheet – Offsetting (formerly FASB Interpretation No. 41, "Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements"), describes the circumstances in which amounts recognized as payables under repurchase agreements may be offset against amounts recognized as receivables under reverse repurchase agreements and reported as a net amount in the balance sheet. The reporting entity's choice to offset or not to offset payables and receivables under ASC Subtopic 210-20 must be applied consistently.

According to the AICPA Audit and Accounting Guide for Depository and Lending Institutions, ASC Subtopic 210-20 does not apply to securities borrowing or lending transactions. Therefore, for purposes of the Report of Condition, banks should not offset securities borrowing and lending transactions in the balance sheet unless all the conditions set forth in ASC Subtopic 210-20 are met.

See also "reciprocal balances."

One-Day Transaction: See "federal funds transactions."

Option: See "derivative contracts."

Organization Costs: See "start-up activities."

Other Depository Institutions in the U.S.: See "depository institutions in the U.S."

Other Real Estate Owned: See "foreclosed assets" and the instruction to Schedule RC-M, item 3.

Overdraft: An overdraft can be either planned or unplanned. An unplanned overdraft occurs when a depository institution honors a check or draft drawn against a deposit account when insufficient funds are on deposit and there is no advance contractual agreement to honor the check or draft. When a contractual agreement has been made in advance to allow such credit extensions, overdrafts are referred to as planned or prearranged. Any overdraft, whether planned or unplanned, is an extension of credit and is to be treated and reported as a "loan" rather than being treated as a negative deposit balance.

Planned overdrafts in depositors' accounts are to be classified in Schedule RC-C, part I, by type of loan according to the nature of the overdrawn depositor. For example, a planned overdraft by a commercial customer is to be classified as a "commercial and industrial loan."

Unplanned overdrafts in depositors' accounts are to be classified in Schedule RC-C, part I, as "All other loans," unless the depositor is a depository institution, a foreign government or foreign official institution, or a state or political subdivision in the U.S. Such unplanned overdrafts would be reported in Schedule RC-C, part I, item 2, "Loans to depository institutions and acceptances of other banks," item 7, "Loans to foreign governments and official institutions," and item 8, "Obligations (other than securities and leases) of states and political subdivisions in the U.S.," respectively.

For purposes of treatment of overdrafts in depositors' accounts, a group of related transaction accounts of a single type (i.e., demand deposit accounts or NOW accounts, but not a combination thereof) maintained in the same right and capacity by a customer (a single legal entity) that is established under a bona fide cash management arrangement by this customer function as, and are regarded as, one account rather than as multiple separate accounts. In such a situation, overdrafts in one or more of the transaction accounts within the group are not to be classified as loans unless there is a net overdraft position in the group of related transaction accounts taken as a whole. (NOTE: Affiliates and subsidiaries are considered separate legal entities.) For further information, see "cash management arrangements."

The reporting bank's overdrafts on deposit accounts it holds with other banks (i.e., its "due from" accounts) are to be reported as borrowings in Schedule RC, item 16, except overdrafts arising in connection with checks or drafts drawn by the reporting bank and drawn on, or payable at or through, another depository institution either on a zero-balance account or on an account that is not routinely maintained with sufficient balances to cover checks or drafts drawn in the normal course of business during the period until the amount of the checks or drafts is remitted to the other depository institution (in which case, report the funds received or held in connection with such checks or drafts as deposits in Schedule RC-E until the funds are remitted).

Participations: See "transfers of financial assets."

Participations in Acceptances: See "bankers acceptances."

Participations in Pools of Securities: See "repurchase/resale agreements."

Pass-through Reserve Balances: Under the Monetary Control Act of 1980, and as reflected in Federal Reserve Regulation D, depository institutions that are members of the Federal Reserve System must maintain their required reserves (in excess of vault cash) directly with a Federal Reserve Bank. However, nonmember depository institutions may maintain their required reserves (in excess of vault cash) in one of two ways: either (1) directly with a Federal Reserve Bank or (2) indirectly in an account with another institution (referred to here as a "correspondent"), which, in turn, is required to

Pass-through Reserve Balances (cont.):
pass the reserves through to a Federal Reserve Bank. This second type of account is called a "pass-through account," and a depository institution passing its reserves to the Federal Reserve through a correspondent is referred to here as a "respondent." This pass-through reserve relationship is legally and for supervisory purposes considered to constitute an asset/debt relationship between the respondent and the correspondent, and an asset/debt relationship between the correspondent and the Federal Reserve. The required reporting of the "pass-through reserve balances" reflects this structure of asset/debt relationships.

In the balance sheet of the respondent bank, the pass-through reserve balances are to be treated as a claim on the correspondent (not as a claim on the Federal Reserve) and, as such, are to be reflected in the balance sheet of the Report of Condition, Schedule RC, item 1.a, "Noninterest-bearing balances and currency and coin," or item 1.b, "Interest-bearing balances," as appropriate. For respondent banks with foreign offices or with $300 million or more in total assets, the pass-through reserve balances would also be reflected in Schedule RC-A, item 2, "Balances due from depository institutions in the U.S."

In the balance sheet of the correspondent bank, the pass-through reserve balances are to be treated as balances due to respondents and, to the extent that the balances have actually been passed through to the Federal Reserve, as balances due from the Federal Reserve. The balances due to respondents are to be reflected in the balance sheet of the Report of Condition, Schedule RC, item 13.a, "Deposits in domestic offices," and on in Schedule RC-E, Deposit Liabilities, (part I), item 4.[1] The balances due from the Federal Reserve are to be reflected on the balance sheet in Schedule RC, item 1.b, "Interest-bearing balances," and, for correspondent banks with foreign offices or with $300 million or more in total assets, in Schedule RC-A, item 4.

Perpetual Preferred Stock: See "preferred stock."

Placements and Takings: Placements and takings are deposits between a foreign office of the reporting bank and a foreign office of another bank and are to be treated as due from or due to depository institutions. Such transactions are always to be reported gross and are not to be netted as reciprocal balances.

Pooling of Interests: See "business combinations."

Preauthorized Transfer Account: See "deposits."

Preferred Stock: Preferred stock is a form of ownership interest in a bank or other company which entitles its holders to some preference or priority over the owners of common stock, usually with respect to dividends or asset distributions in a liquidation.

Limited-life preferred stock is preferred stock that has a stated maturity date or that can be redeemed at the option of the holder. It excludes those issues of preferred stock that automatically convert into perpetual preferred stock or common stock at a stated date.

Perpetual preferred stock is preferred stock that does not have a stated maturity date or that cannot be redeemed at the option of the holder. It includes those issues of preferred stock that automatically convert into common stock at a stated date.

[1] When an Edge or Agreement Corporation acts as a correspondent, its balances due to respondents are to be reflected on the FFIEC 031 report form in Schedule RC, item 13.b, "Deposits in foreign offices," and in Schedule RC-E, part II, item 2.

<u>Premiums and Discounts:</u> A <u>premium</u> arises when a bank purchases a security, loan, or other asset at a price in excess of its par or face value, typically because the current level of interest rates for such assets is less than its contract or stated rate of interest. The difference between the purchase price and par or face value represents the premium, which <u>all</u> banks are required to amortize.

A <u>discount</u> arises when a bank purchases a security, loan, or other asset at a price below its par or face value, typically because the current level of interest rates for such assets is greater than its contract or stated rate of interest. A discount is also present on instruments that do not have a stated rate of interest such as U.S. Treasury bills and commercial paper. The difference between par or face value and the purchase price represents the discount that <u>all</u> banks are required to accrete.

Premiums and discounts are accounted for as adjustments to the yield on an asset over the life of the asset. A premium must be amortized and a discount must be accreted from date of purchase to maturity, <u>not</u> to call or put date. The preferable method for amortizing premiums and accreting discounts involves the use of the interest method for accruing income on the asset. The objective of the interest method is to produce a constant yield or rate of return on the carrying value of the asset (par or face value plus unamortized premium or less unaccreted discount) at the beginning of each amortization period over the asset's remaining life. The difference between the periodic interest income that is accrued on the asset and interest at the stated rate is the periodic amortization or accretion. However, a straight-line method of amortization or accretion is acceptable if the results are not materially different from the interest method.

A premium or discount may also arise when the reporting bank, acting either as a lender or a borrower, is involved in an exchange of a note for assets other than cash and the interest rate is either below the market rate or not stated, or the face amount of the note is materially different from the fair value of the noncash assets exchanged. The noncash assets and the related note shall be recorded at either the fair value of the noncash assets or the market value of the note, whichever is more clearly determinable. The market value of the note would be its present value as determined by discounting all future payments on the note using an appropriate interest rate, i.e., a rate comparable to that on new loans of similar risk. The difference between the face amount and the recorded value of the note is a premium or discount. This discount or premium shall be accounted for as an adjustment of the interest income or expense over the life of the note using the interest method described above.

For further information, see ASC Subtopic 835-30, Interest – Imputation of Interest (formerly APB Opinion No. 21, "Interest on Receivables and Payables").

<u>Purchase Acquisition:</u> <u>See</u> "business combinations."

<u>Purchased Impaired Loans and Debt Securities:</u> Purchased impaired loans and debt securities are loans and debt securities that a bank has purchased, including those acquired in a purchase business combination, where there is evidence of deterioration of credit quality since the origination of the loan or debt security and it is probable, at the purchase date, that the bank will be unable to collect all contractually required payments receivable. Such loans and debt securities acquired in fiscal years beginning after December 15, 2004, must be accounted for in accordance with ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"). ASC Subtopic 310-30 does not apply to loans that a bank has originated.

Under ASC Subtopic 310-30, a purchased impaired loan or debt security is initially recorded at its purchase price (in a purchase business combination, the present value of amounts to be received). ASC Subtopic 310-30 limits the yield that may be accreted on the loan or debt security (the accretable yield) to the excess of the bank's estimate of the undiscounted principal, interest, and other cash flows expected at acquisition to be collected on the asset over the bank's initial investment in the asset. The excess of contractually required cash flows over the cash flows expected to be collected on the loan or debt security, which is referred to as the nonaccretable difference, must not be recognized as an adjustment of yield, loss accrual, or valuation allowance. Neither the accretable yield nor the

Purchased Impaired Loans and Debt Securities (cont.):

nonaccretable difference may be shown on the balance sheet (Schedule RC). After acquisition, increases in the cash flows expected to be collected generally should be recognized prospectively as an adjustment of the asset's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as an impairment.

ASC Subtopic 310-30 does not prohibit a bank from placing purchased impaired loans and debt securities in nonaccrual status. Because a loan or debt security accounted for in accordance with ASC Subtopic 310-30 has evidence of deterioration of credit quality since origination, a purchasing bank must determine upon acquisition whether it is appropriate to recognize the accretable yield as income over the life of the loan or debt security using the interest method. In order to apply the interest method, the bank must have sufficient information to reasonably estimate the amount and timing of the cash flows expected to be collected on a purchased impaired loan or debt security. When the amount and timing of the cash flows cannot be reasonably estimated at acquisition, the bank should place the loan or debt security in nonaccrual status and then apply the cost recovery method or cash basis income recognition to the asset. In addition, if a purchased impaired loan or debt security is acquired primarily for the rewards of ownership of the underlying collateral, accrual of income is inappropriate and the loan or debt security should be placed in nonaccrual status. When accrual of income on a purchased impaired loan or debt security is appropriate (either at acquisition or at a later date when the amount and timing of the cash flows can be reasonably estimated), the delinquency status of the asset should be determined in accordance with its contractual repayment terms for purposes of Schedule RC-N, Past Due and Nonaccrual Loans, Leases, and Other Assets.

ASC Subtopic 310-30 prohibits a bank from "carrying over" or creating loan loss allowances in the initial accounting for purchased impaired loans. This prohibition applies to the purchase of an individual impaired loan, a pool or group of impaired loans, and impaired loans acquired in a business combination. However, if, upon evaluation of a purchased impaired loan held for investment (and not accounted for as a debt security) subsequent to acquisition, based on current information and events, it is probable that a bank is unable to collect all cash flows expected at acquisition (plus additional cash flows expected to be collected arising from changes in estimate after acquisition) on the loan, the purchased impaired loan should be considered impaired for purposes of establishing an allowance pursuant to ASC Subtopic 450-20, Contingencies – Loss Contingencies (formerly FASB Statement No. 5, "Accounting for Contingencies") or ASC Topic 310, Receivables (formerly FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"), as appropriate. Banks should include such post-acquisition allowances in the bank's allowance for loan and lease losses as reported in Schedule RC, item 4.c, and Schedule RI-B, part II, item 7, and disclose the amount of these allowances in Schedule RI-B, part II, Memorandum item 4.

In Schedule RC-C, part I, Loans and Leases, banks should report the carrying amount (before any loan loss allowance) of, i.e., the recorded investment in, a purchased impaired loan in the appropriate loan category (items 1 through 9). Neither the accretable yield nor the nonaccretable difference associated with a purchased impaired loan should be reported as unearned income in Schedule RC-C, part I, item 11. In addition, banks should report in Schedule RC-C, part I, Memorandum items 7.a and 7.b, the outstanding balance and carrying amount (before any loan loss allowance), respectively, of all purchased impaired loans reported as held for investment in Schedule RC-C, part I.

For further information, refer to ASC Subtopic 310-30.

Put Option: See "derivative contracts."

Real Estate ADC Arrangements: See "acquisition, development, or construction (ADC) arrangements."

Real Estate, Loan Secured By: See "loan secured by real estate."

Reciprocal Balances: Reciprocal balances arise when two depository institutions maintain deposit accounts with each other; that is, when a reporting bank has both a due to and a due from balance with another depository institution.

For purposes of the balance sheet of the Report of Condition, reciprocal balances between the reporting bank and other depository institutions may be reported on a net basis when a right of setoff exists. See the Glossary entry for "offsetting" for the conditions that must be met for a right of setoff to exist.

Renegotiated Troubled Debt: See "troubled debt restructurings."

Reorganizations: See "business combinations."

Repurchase/Resale Agreements: A repurchase agreement is a transaction involving the "sale" of financial assets by one party to another, subject to an agreement by the "seller" to repurchase the assets at a specified date or in specified circumstances. A resale agreement (also known as a reverse repurchase agreement) is a transaction involving the "purchase" of financial assets by one party from another, subject to an agreement by the "purchaser" to resell the assets at a specified date or in specified circumstances.

As stated in the AICPA's Audit and Accounting Guide for Banks and Savings Institutions, dollar repurchase agreements (also called dollar rolls) are agreements to sell and repurchase similar but not identical securities. The dollar roll market consists primarily of agreements that involve mortgage-backed securities (MBS). Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and generally have different principal amounts.

General rule – Consistent with ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended), repurchase and resale agreements involving financial assets (e.g., securities and loans), including dollar repurchase agreements, are either reported as (a) secured borrowings and loans or (b) sales and forward repurchase commitments based on whether the transferring ("selling") institution maintains control over the transferred assets. (See the Glossary entry for "transfers of financial assets" for further discussion of control criteria.)

Repurchase/Resale Agreements (cont.):

If a repurchase agreement both entitles and obligates the "selling" bank to repurchase or redeem the transferred assets from the transferee ("purchaser"), the "selling" bank should report the transaction as a secured borrowing if and only if the following conditions have been met:

(1) The assets to be repurchased or redeemed are the same or "substantially the same" as those transferred, as defined by ASC Topic 860.

(2) The "selling" institution has the ability to repurchase or redeem the transferred assets on substantially the agreed terms, even in the event of default by the transferee ("purchaser"). This ability is presumed to exist if the "selling" bank has obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

(3) The agreement is to repurchase or redeem the transferred assets before maturity, at a fixed or determinable price.

(4) The agreement is entered into concurrently with the transfer.

Participations in pools of securities are to be reported in the same manner as security repurchase/resale transactions.

<u>Repurchase agreements reported as secured borrowings</u> – If a repurchase agreement qualifies as a secured borrowing, the "selling" institution should report the transaction as indicated below based on whether the agreement involves a security or some other financial asset.

(1) Securities "sold" under agreements to repurchase are reported in Schedule RC, item 14.b, "Securities sold under agreements to repurchase."

(2) Financial assets (other than securities) "sold" under agreements to repurchase are reported as follows:

   (a) If the repurchase agreement has an original maturity of one business day (or is under a continuing contract) and is in immediately available funds, it should be reported in Schedule RC, item 14.a, "Federal funds purchased (in domestic offices)," if it is in a domestic office, and in Schedule RC-M, item 5.b, "Other borrowings," if it is in a foreign office.
   (b) If the repurchase agreement has an original maturity of more than one business day or is not in immediately available funds, it should be reported in Schedule RC-M, item 5.b.

In addition, the "selling" institution may need to record further entries depending on the terms of the agreement. If the "purchaser" has the right to sell or repledge noncash assets, the "selling" institution should recategorize the transferred financial assets as "assets receivable" and report them in Schedule RC, item 11, "Other assets." Otherwise, the financial assets should continue to be reported in the same asset category as before the transfer (e.g., securities should continue to be reported in Schedule RC, item 2, "Securities," or item 5, "Trading assets," as appropriate).

<u>Resale agreements reported as secured borrowings</u>. Similarly, if a resale agreement qualifies as a secured borrowing, the "purchasing" institution should report the transaction as indicated below based on whether the agreement involves a security or some other financial asset.

(1) Securities "purchased" under agreements to resell are reported in Schedule RC, item 3.b, "Securities purchased under agreements to resell."

(2) Financial assets (other than securities) "purchased" under agreements to resell are reported as follows:

Repurchase/Resale Agreements (cont.):

(a) If the resale agreement has an original maturity of one business day (or is under a continuing contract) and is in immediately available funds, it should be reported in Schedule RC, item 3.a, "Federal funds sold (in domestic offices)," if it is in a domestic office, and in Schedule RC, item 4.b, "Loans and leases, net of unearned income," if it is in a foreign office.

(b) If the resale agreement has an original maturity of more than one business day or is not in immediately available funds, it should be reported in Schedule RC, item 4.b.

In addition, the "purchasing" institution may need to record further entries depending on the terms of the agreement. If the "purchasing" institution has the right to sell the noncash assets it has "purchased" and sells these assets, it should recognize the proceeds from the sale and report its obligation to return the assets in Schedule RC, item 20, "Other liabilities." If the "selling" institution defaults under the terms of the repurchase agreement and is no longer entitled to redeem the noncash assets, the "purchasing" bank should recognize these assets on its own balance sheet (e.g., securities should be reported in Schedule RC, item 2, "Securities," or item 5, "Trading assets," as appropriate) and initially measure them at fair value. However, if the "purchasing" bank has already sold the assets it has "purchased," it should derecognize its obligation to return the assets. Otherwise, the "purchasing" bank should not recognize the transferred financial assets (i.e., the financial assets "purchased" under the resale agreement) on its balance sheet.

Repurchase/resale agreements reported as sales – If a repurchase agreement does not qualify as a secured borrowing under ASC Topic 860, the selling bank should account for the transaction as a sale of financial assets and a forward repurchase commitment. The selling bank should remove the transferred assets from its balance sheet, record the proceeds from the sale of the transferred assets (including the forward repurchase commitment), and record any gain or loss on the transaction. Similarly, if a resale agreement does not qualify as a borrowing under ASC Topic 860, the purchasing bank should account for the transaction as a purchase of financial assets and a forward resale commitment. The purchasing bank should record the transferred assets on its balance sheet, initially measure them at fair value, and record the payment for the purchased assets (including the forward resale commitment).

Reserve Balances, Pass-through: See "pass-through reserve balances."

Retail Sweep Arrangements: See “deposits.”

Sales of Assets for Risk-Based Capital Purposes: This entry should be read in conjunction with the banking agencies' final rule revising the regulatory capital treatment of recourse arrangements and direct credit substitutes, including residual interests and credit-enhancing interest-only strips, which was published on November 29, 2001. This entry provides guidance for determining whether sales of loans, securities, receivables, and other assets are subject to the agencies' risk-based capital standards and are reportable in Schedule RC-R, Regulatory Capital, and Schedule RC-S, Servicing, Securitization, and Asset Sale Activities. For information on the reporting of transfers of financial assets for purposes of the balance sheet, income statement, and related schedules, see the Glossary entry for "transfers of financial assets."

For purposes of reporting in Schedules RC-R and RC-S, some transfers of assets that qualify as sales under generally accepted accounting principles are subject to the agencies' risk-based capital standards because they meet the following definition of "recourse" that is set forth in those standards.

Definition of "recourse" for risk-based capital purposes – As defined in the agencies' risk-based capital standards, recourse means an arrangement in which a bank retains, in form or in substance, any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles) that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on an asset it has sold, then the retention of any credit risk is recourse.

Sales of Assets for Risk-Based Capital Purposes (cont.):

(3) Among the transfers where credit risk has been retained by the seller and that should be considered by the seller as asset sales with recourse for purposes of risk-based capital and Schedules RC-R and RC-S are arrangements such as the following (this list is illustrative of the principles involved in the application of the definition of "recourse" and is not all-inclusive) –

(a) the sale of an asset with a realistic bona fide put option allowing the purchaser, at its option, to return the asset to the seller;

(b) the sale of an asset guaranteed by a standby letter of credit issued by the seller;

(c) the sale of an asset guaranteed by a standby letter of credit issued by any other party in which the credit risk on the asset sold, either directly or indirectly, rests with the seller;

(d) the sale of an asset guaranteed by an insurance contract in which the seller, either directly or indirectly, indemnifies or otherwise protects the insurer in any manner against credit risk; and

(e) sales and securitizations of assets which use contractual cash flows (e.g., interest-only strips receivable and so-called "spread accounts"), retained subordinated interests, or retained securities (e.g., collateral invested amounts and cash collateral accounts) as credit enhancements.

(4) The sale of a loan or other asset subject to an agreement under which the seller will pass through to the purchaser a rate of interest that differs from the stated rate of interest on the transferred asset would not, for this reason alone, require the transaction to be treated as an asset sale with recourse for risk-based capital purposes provided (1) the seller's obligation to pass interest through to the purchaser is contingent upon the continued interest payment performance of the underlying obligor of the transferred asset (i.e., the seller has no obligation to pass interest through if the obligor defaults in whole or in part on interest or principal) and (2) none of the other characteristics of the sale or participation causes the transaction to meet the definition of "recourse."

(5) The definition of "recourse" applies to all transfers of assets, including sales of a single asset or of a pool of assets and sales of participations in a single asset or in a pool of assets (whether of similar or dissimilar instruments). In participations that qualify for sale treatment under generally accepted accounting principles and are not "syndications" (as described in the Glossary item for that term), the seller of the participations should handle the transfer of shares to participants in accordance with the definition of "recourse", even though the assets being participated were acquired or accumulated for the express purpose of issuing participations and even though the participation was prearranged with the purchasers of the participations. However, the definition of "recourse" does not apply to the initial operation and distribution of participations in the form of syndications, since in a syndication there is no transfer of assets involved of the type to which this definition is addressed. Any subsequent transfers of shares, or parts of shares, in a syndicated loan would be subject to the "recourse" definition.

(6) The definition of "recourse" (and these interpretations and illustrations) is also applicable to asset transfers that are made to special or limited purpose entities that are not technically affiliated with the seller. Regardless of the legal structure of the transaction, if credit risk is retained by the seller, either contractually or otherwise, either directly or indirectly, the seller should treat the transaction as an asset sale with recourse for purposes of risk-based capital and Schedules RC-R and RC-S even if the sale to the special purpose entity is stated as being without recourse.

Savings Deposits: See "deposits."

<u>Securities Activities:</u> Institutions should categorize their investments in debt securities and certain equity securities (i.e., those equity securities with readily determinable fair values) as trading, available-for-sale, or held-to-maturity consistent with ASC Topic 320, Investments-Debt and Equity Securities (formerly FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," as amended). Management should periodically reassess its security categorization decisions to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling them in the near term should be classified as trading assets. Trading activity includes active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. Institutions may also elect to report securities within the scope of ASC Topic 320 at fair value in accordance with ASC Subtopic 825-10, Financial Instruments – Overall (formerly FASB Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities"). Securities for which the fair value option is elected should be classified as trading assets with unrealized gains and losses recognized in current earnings and regulatory capital. In general, the fair value option may be elected for an individual security only when it is first recognized and the election is irrevocable.

Held-to-maturity securities are debt securities that an institution has the positive intent and ability to hold to maturity. Held-to-maturity securities are generally reported at amortized cost. Securities not categorized as trading or held-to-maturity must be reported as available-for-sale. An institution must report its available-for-sale securities at fair value on the balance sheet, but unrealized gains and losses are excluded from earnings and reported in a separate component of equity capital (i.e., in Schedule RC, item 26.b, "Accumulated other comprehensive income").

When the fair value of a security is less than its (amortized) cost basis, the security is impaired and the impairment is either temporary or other than temporary. Under ASC Topic 320, institutions must determine whether an impairment of an individual available-for-sale or held-to-maturity security is other than temporary. To make this determination, institutions should apply applicable accounting guidance including, but not limited to, ASC Topic 320, ASC Subtopic 325-40, Investments-Other – Beneficial Interests in Securitized Financial Assets (formerly EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," as amended), and SEC Staff Accounting Bulletin No. 59, Other Than Temporary Impairment of Certain Investments in Equity Securities (Topic 5.M. in the Codification of Staff Accounting Bulletins).

Under ASC Topic 320, if an institution intends to sell a debt security or it is more likely than not that it will be required to sell the debt security before recovery of its amortized cost basis, an other-than-temporary impairment has occurred and the entire difference between the security's amortized cost basis and its fair value at the balance sheet date must be recognized in earnings. In these cases, the fair value of the debt security would become its new amortized cost basis.

In addition, under ASC Topic 320, if the present value of cash flows expected to be collected on a debt security is less than its amortized cost basis, a credit loss exists. In this situation, if an institution does not intend to sell the security and it is not more likely than not that the institution will be required to sell the debt security before recovery of its amortized cost basis less any current-period credit loss, an other-than-temporary impairment has occurred. The amount of the total other-than-temporary impairment related to the credit loss must be recognized in earnings, but the amount of the total impairment related to other factors must be recognized in other comprehensive income, net of applicable taxes.

Other-than-temporary impairment losses on held-to-maturity and available-for-sale debt securities that must be recognized in earnings should be included in Schedule RI, items 6.a and 6.b, respectively. Other-than-temporary impairment losses that are to be recognized in other comprehensive income, net

Securities Activities (cont.):

of applicable taxes, should be reported in item 10 of Schedule RI-A, Changes in Bank Equity Capital, and included on the balance sheet in Schedule RC, item 26.b, "Accumulated other comprehensive income." Information about other-than-temporary impairment losses on held-to-maturity and available-for-sale debt securities that occur during the current calendar year-to-date reporting period should be reported in Schedule RI, Memorandum items 14.a through 14.c. For a held-to-maturity debt security on which the institution has recognized an other-than-temporary impairment loss related to factors other than credit loss in other comprehensive income, the institution should report the carrying value of the debt security in Schedule RC, item 2.a, and in column A of Schedule RC-B, Securities. Under ASC Topic 320, this carrying value should be the fair value of the held-to-maturity debt security as of the date of the most recently recognized other-than-temporary impairment loss adjusted for subsequent accretion of the impairment loss related to factors other than credit loss.

The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized in earnings and regulatory capital. This will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale. The following practices are considered trading activities:

(1) Gains Trading – Gains trading is characterized by the purchase of a security and the subsequent sale of the same security at a profit after a short holding period, while securities acquired for this purpose that cannot be sold at a profit are typically retained in the available-for-sale or held-to-maturity portfolio. Gains trading may be intended to defer recognition of losses, as unrealized losses on available-for-sale and held-to-maturity debt securities do not directly affect regulatory capital and generally are not reported in income until the security is sold.

(2) When-Issued Securities Trading – When-issued securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchase of a "when-issued" security acquires the risks and rewards of owning a security and may sell the when-issued security at a profit before having to take delivery and pay for it. Because such transactions are intended to generate profits from short-term price movements, they should be categorized as trading.

(3) Pair-offs – Pair-offs are security purchase transactions that are closed-out or sold at, or prior to, settlement date. In a pair-off, an institution commits to purchase a security. Then, prior to the predetermined settlement date, the institution will pair-off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and the sale price to the counterparty. Pair-offs may also involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance sheet derivative contracts.

(4) Extended Settlements – In the U.S., regular-way settlement for federal government and federal agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date. For mortgage-backed securities, it can be up to 60 days or more after the trade date. The use of extended settlements may be offered by securities dealers in order to facilitate speculation on the part of the purchaser, often in connection with pair-off transactions. Securities acquired through the use of a settlement period in excess of the regular-way settlement periods in order to facilitate speculation should be reported as trading assets.

(5) Repositioning Repurchase Agreements – A repositioning repurchase agreement is a funding technique offered by a dealer in an attempt to enable an institution to avoid recognition of a loss. Specifically, an institution that enters into a "when-issued" trade or a "pair-off" (which may include an extended settlement) that cannot be closed out at a profit on the payment or settlement date will be provided dealer financing in an effort to fund its speculative position until the security can be sold at a gain. The institution purchasing the security typically pays the dealer a small margin that

Securities Activities (cont.):

approximates the actual loss in the security. The dealer then agrees to fund the purchase of the security, typically buying it back from the purchaser under a resale agreement. Any securities acquired through a dealer financing technique such as a repositioning repurchase agreement that is used to fund the speculative purchase of securities should be reported as trading assets.

(6) Short Sales – A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on a fall in the price of the security. (For further information, see the Glossary entry for "short position.")

One other practice, referred to as "adjusted trading," is not acceptable under any circumstances. Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the contemporaneous purchase and booking of a different security, frequently a lower-rated or lower quality issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive cost basis for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 U.S.C. Sections 1001–False Statements or Entries and 1005–False Entries.

See also "trading account."

Securities Borrowing/Lending Transactions: Securities borrowing/lending transactions are typically initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. A transferee ("borrower") of securities generally is required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed."

Most securities borrowing/lending transactions do not qualify as sales under ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended), because the agreement entitles and obligates the securities lender to repurchase or redeem the transferred assets before their maturity. (See the Glossary entry for "transfers of financial assets" for further discussion of sale criteria.) When such transactions do not qualify as sales, securities lenders and borrowers should account for the transactions as secured borrowings in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" by the securities lender is considered the amount borrowed and the securities "loaned" are considered pledged as collateral against the amount borrowed. The "loaned" securities should continue to be reported on the securities lender's balance sheet as available-for-sale securities, held-to-maturity securities, or trading assets, as appropriate. "Loaned" securities that are reported as available-for-sale or held-to-maturity securities in Schedule RC-B, Securities, should also be reported as "Pledged securities" in Memorandum item 1 of that schedule. Similarly, "loaned" securities that are reported as trading assets in Schedule RC-D, Trading Assets and Liabilities, should be reported as "Pledged securities" in Memorandum item 4.a of that schedule.

If the securities borrowing/lending transaction meets the criteria for a sale under ASC Topic 860, the lender of the securities should remove the securities from its balance sheet, record the proceeds from the sale of the securities (including the forward repurchase commitment), and recognize any gain or loss on the transaction. The borrower of the securities should record the securities on its balance sheet at fair value and record the payment for the purchased assets (including the forward resale commitment).

Securities, Participations in Pools of: See "repurchase/resale agreements."

Servicing Assets and Liabilities (cont.):

For purposes of these reports, servicing assets resulting from contracts to service loans secured by real estate (as defined for Schedule RC-C, part I, item 1, in the Glossary entry for "Loans secured by real estate") should be reported in Schedule RC-M, item 2.a, "Mortgage servicing assets." Servicing assets resulting from contracts to service all other financial assets should be reported in Schedule RC-M, item 2.b, "Purchased credit card relationships and nonmortgage servicing assets." When reporting the carrying amount of mortgage servicing assets in Schedule RC-M, item 2.a, and nonmortgage servicing assets in Schedule RC-M, item 2.b, banks should include all classes of servicing accounted for under the amortization method as well as all classes of servicing accounted for under the fair value measurement method. The fair value of all recognized mortgage servicing assets should be reported in Schedule RC-M, item 2.a.(1), regardless of the subsequent measurement method applied to these assets. The servicing asset carrying amounts reported in Schedule RC-M, items 2.a and 2.b, even if these amounts include fair values, should be used when determining the lesser of 90 percent of the fair value of these assets and 100 percent of their carrying amount for regulatory capital calculation purposes in Schedule RC-R. Changes in the fair value of any class of servicing assets and servicing liabilities accounted for under the fair value measurement method should be included in earnings in Schedule RI, item 5.f, "Net servicing fees." In addition, certain information about assets serviced by the reporting bank should be reported in Schedule RC-S, Servicing, Securitization, and Asset Sale Activities.

Settlement Date Accounting: See "trade date and settlement date accounting."

Shell Branches: Shell branches are limited service branches that do not conduct transactions with residents, other than with other shell branches, in the country in which they are located. Transactions at shell branches are usually initiated and effected by their head office or by other related branches outside the country in which the shell branches are located, with records and supporting documents maintained at the initiating offices. Examples of such locations are the Bahamas and the Cayman Islands.

Short Position: When a bank sells an asset that it does not own, it has established a short position. If on the report date a bank is in a short position, it shall report its liability to purchase the asset in Schedule RC, item 15, "Trading liabilities." In this situation, the right to receive payment shall be reported in Schedule RC-F, item 6, "All other assets." Short positions shall be reported gross. Short trading positions shall be revalued consistent with the method used by the reporting bank for the valuation of its trading assets.

Significant Subsidiary: See "subsidiaries."

Standby Letter of Credit: See "letter of credit."

Start-Up Activities: Guidance on the accounting and reporting for the costs of start-up activities, including organization costs, is set forth in ASC Subtopic 720-15, Other Expenses – Start-Up Costs (formerly AICPA Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities"). A summary of this accounting guidance follows. For further information, see ASC Subtopic 720-15.

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 some new operation. Start-up activities include activities related to organizing a new entity, such as a new bank, the costs of which are commonly referred to as organization costs.[1]

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[1] Organization costs for a bank are the direct costs incurred to incorporate and charter the bank. Such costs include, but are not limited to, 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.

Start-Up Activities (cont.):

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 not start-up costs, but the costs of using such assets that are allocated to start-up activities (e.g., depreciation of computers) 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.

Pre-opening income earned and expenses incurred from the bank's inception until the date the bank commences operations should be reported in the Report of Income using one of the two following methods, consistent with the manner in which the bank reports pre-opening income and expenses for other financial reporting purposes:

(1) Pre-opening income and expenses for the entire period from the bank's inception until the date the bank commences operations should be reported in the appropriate items of Schedule RI, Income Statement, each quarter during the calendar year in which operations commence; or

(2) Pre-opening income and expenses for the period from the bank's inception until the beginning of the calendar year in which the bank commences operations should be included, along with the bank's opening (original) equity capital, in Schedule RI-A, item 5, "Sale, conversion, acquisition, or retirement of capital stock, net." The net amount of these pre-opening income and expenses should be identified and described in Schedule RI-E, item 7. Pre-opening income earned and expenses incurred during the calendar year in which the bank commences operations should be reported in the appropriate items of Schedule RI, Income Statement, each quarter during the calendar year in which operations commence.

The organization costs of forming a holding company and the costs of other holding company start-up activities are sometimes paid by the bank that will be owned by the holding company. Because these are the holding company's costs, whether or not the holding company formation is successful, they should not be reported as expenses of the bank. Accordingly, any unreimbursed costs paid by the bank on behalf of the holding company should be reported as a cash dividend to the holding company in Schedule RI-A, item 9. In addition, if a new bank and holding company are being formed at the same time, the costs of the bank's start-up activities, including its organization costs, should be reported as start-up costs for the bank. If the holding company pays these costs for the bank but is not reimbursed by the bank, the bank should treat the holding company's forgiveness of payment as a capital contribution, which should be reported in Schedule RI-A, item 11, "Other transactions with parent holding company," and in Schedule RI-E, item 5.

STRIPS: See "coupon stripping, Treasury receipts, and STRIPS."

Subordinated Notes and Debentures: A subordinated note or debenture is a form of debt issued by a bank or a consolidated subsidiary. When issued by a bank, a subordinated note or debenture is not insured by a federal agency, is subordinated to the claims of depositors, and has an original weighted average maturity of five years or more. Such debt shall be issued by a bank with the approval of, or under the rules and regulations of, the appropriate federal bank supervisory agency and is to be reported in Schedule RC, item 19, "Subordinated notes and debentures."

When issued by a subsidiary, a note or debenture may or may not be explicitly subordinated to the deposits of the parent bank and is to be reported in Schedule RC, item 16, "Other borrowed money," or item 19, "Subordinated notes and debentures," as appropriate.

Those subordinated notes and debentures that are to be reported in Schedule RC, item 19, include mandatory convertible debt.

<u>Subsidiaries:</u> The treatment of subsidiaries in the Reports of Condition and Income depends upon the degree of ownership held by the reporting bank.

A <u>majority-owned subsidiary</u> of the reporting bank is a subsidiary in which the parent bank directly or indirectly owns more than 50 percent of the outstanding voting stock.

A <u>significant subsidiary</u> of the reporting bank is a majority-owned subsidiary that meets any one or more of the following tests:

(1) The bank's direct and indirect investment in and advances to the subsidiary equals five percent or more of the total equity capital of the parent bank.

NOTE: For the purposes of this test, the amount of direct and indirect investments and advances is either (a) the amount carried on the books of the parent bank or (b) the parent's proportionate share in the total equity capital of the subsidiary, whichever is greater.

(2) The parent bank's proportional share (based on equity ownership) of the subsidiary's gross operating income or revenue amounts to five percent or more of the gross operating income or revenue of the consolidated parent bank.

(3) The subsidiary's income or loss before income taxes amounts to five percent or more of the parent bank's income or loss before income taxes.

(4) The subsidiary is, in turn, the parent of one or more subsidiaries which, when consolidated with the subsidiary, constitute a significant subsidiary as defined in one or more of the above tests.

An <u>associated company</u> is a corporation in which the bank, directly or indirectly, owns 20 to 50 percent of the outstanding voting stock *and* over which the bank exercises significant influence. This 20 to 50 percent ownership is presumed to carry "significant" influence unless the bank can demonstrate the contrary to the satisfaction of the appropriate federal supervisory authority.

A <u>corporate joint venture</u> is a corporation owned and operated by a group of banks or other businesses ("joint venturers"), no one of which has a majority interest, as a separate and specific business or project for the mutual benefit of the joint venturers. Each joint venturer may participate, directly or indirectly, in the management of the joint venture. An entity that is a majority-owned subsidiary of one of the joint venturers is not a corporate joint venture.

The equity ownership in majority-owned subsidiaries that are not consolidated on the Reports of Condition and Income (in accordance with the guidance in the General Instructions on the Scope of the "Consolidated Bank" Required to be Reported in the Submitted Reports) and in associated companies is accounted for using the equity method of accounting and is reported in Schedule RC, item 8, "Investments in unconsolidated subsidiaries and associated companies," or item 9, “Direct and indirect investments in real estate ventures,” as appropriate.

Ownership in a corporate joint venture is to be treated in the same manner as an associated company (defined above) only to the extent that the equity share represents significant influence over management. Otherwise, equity holdings in a joint venture are treated as holdings of corporate stock and income is recognized only when distributed in the form of dividends.

<u>See also</u> “equity method of accounting.”

Suspense Accounts: Suspense accounts are temporary holding accounts in which items are carried until they can be identified and their disposition to the proper account can be made. Such accounts may also be known as interoffice or clearing accounts. The balances of suspense accounts as of the report date should not automatically be reported as "Other assets" or "Other liabilities." Rather, the items included in these accounts should be reviewed and material amounts should be reported in the appropriate accounts of the Reports of Condition and Income.

Syndications: A syndication is a participation, usually involving shares in a single loan, in which several participants agree to enter into an extension of credit under a bona fide binding agreement that provides that, regardless of any event, each participant shall fund and be at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount. In a syndication, the participants agree to the terms of the participation prior to the execution of the final agreement and the contract is executed by the obligor and by all the participants, although there is usually a lead institution organizing or managing the credit. Large commercial and industrial loans, large loans to finance companies, and large foreign loans may be handled through such syndicated participations.

Each participant in the syndicate, including the lead bank, records its own share of the participated loan and the total amount of the loan is not entered on the books of one bank to be shared through transfers of loans. Thus, the initial operation and distribution of this type of participation does not require a determination as to whether a transfer that should be accounted for as a sale has occurred. However, any subsequent transfers of shares, or parts of shares, in the syndicated loan would be subject to the provisions of ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended), governing whether these transfers should be accounted for as a sale or a secured borrowing. (See the Glossary entry for "transfers of financial assets.")

Telephone Transfer Account: See "deposits."

Term Federal Funds: See "federal funds transactions."

Time Deposits: See "deposits."

Trade Date and Settlement Date Accounting: For purposes of the Reports of Condition and Income, the preferred method for reporting transactions in held-to-maturity securities, available-for-sale securities, and trading assets (including money market instruments) other than derivative contracts (see the Glossary entry for "derivative contracts") is on the basis of trade date accounting. However, if the reported amounts under settlement date accounting would not be materially different from those under trade date accounting, settlement date accounting is acceptable. Whichever method a bank elects should be used consistently, unless the bank has elected settlement date accounting and subsequently decides to change to the preferred trade date method.

Under trade date accounting, assets purchased shall be recorded in the appropriate asset category on the trade date and the bank's obligation to pay for those assets shall be reported in Schedule RC-G, item 4, "All other liabilities." Conversely, when an asset is sold, it shall be removed on the trade date from the asset category in which it was recorded, and the proceeds receivable resulting from the sale shall be reported in Schedule RC-F, item 6, "All other assets." Any gain or loss resulting from such transaction shall also be recognized on the trade date. On the settlement date, disbursement of the payment or receipt of the proceeds will eliminate the respective "All other liabilities" or "All other assets" entry resulting from the initial recording of the transaction.

Under settlement date accounting, assets purchased are not recorded until settlement date. On the trade date, no entries are made. Upon receipt of the assets on the settlement date, the asset is reported in the proper asset category and payment is disbursed. The selling bank, on the trade date, would make no entries. On settlement date, the selling bank would reduce the appropriate asset category and reflect the receipt of the payment. Any gain or loss resulting from such transaction would be recognized on the settlement date.

Trading Account: Trading activities typically include (a) regularly underwriting or dealing in securities; interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts; other financial instruments; and other assets for resale, (b) acquiring or taking positions in such items principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements, and (c) acquiring or taking positions in such items as an accommodation to customers or for other trading purposes.

Pursuant to ASC Subtopic 825-10, Financial Instruments – Overall (formerly FASB Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities"), all securities within the scope of ASC Topic 320, Investments-Debt and Equity Securities (formerly FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities"), that a bank has elected to report at fair value under a fair value option with changes in fair value reported in current earnings should be classified as trading securities. In addition, for purposes of these reports, banks may classify assets (other than securities within the scope of ASC Topic 320 for which a fair value option is elected) and liabilities as trading if the bank applies fair value accounting, with changes in fair value reported in current earnings, and manages these assets and liabilities as trading positions, subject to the controls and applicable regulatory guidance related to trading activities. For example, a bank would generally not classify a loan to which it has applied the fair value option as a trading asset unless the bank holds the loan, which it manages as a trading position, for one of the following purposes: (1) for market making activities, including such activities as accumulating loans for sale or securitization; (2) to benefit from actual or expected price movements; or (3) to lock in arbitrage profits.

All trading assets should be segregated from a bank's other assets and reported in Schedule RC, item 5, "Trading assets." In addition, banks that reported average trading assets (Schedule RC-K, item 7) of $2 million or more in any of the four preceding calendar quarters should detail the types of assets and liabilities in the trading account in Schedule RC-D, Trading Assets and Liabilities, and the levels within the fair value measurement hierarchy in which the trading assets and liabilities fall in

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Trading Account (cont.):

Schedule RC-Q, Assets and Liabilities Measured at Fair Value on a Recurring Basis. A bank's failure to establish a separate account for assets that are used for trading purposes does not prevent such assets from being designated as trading for purposes of these reports. For further information, see ASC Topic 320.

All trading account assets should be reported at their fair value with unrealized gains and losses recognized in current income. When a security or other asset is acquired, a bank should determine whether it intends to hold the asset for trading or for investment (e.g., for securities, available-for-sale or held-to-maturity). A bank should not record a newly acquired asset in a suspense account and later determine whether it was acquired for trading or investment purposes. Regardless of how a bank categorizes a newly acquired asset, management should document its decision.

All trading liabilities should be segregated from other transactions and reported in Schedule RC, item 15, "Trading liabilities." The trading liability account includes the fair value of derivative contracts held for trading that are in loss positions and short positions arising from sales of securities and other assets that the bank does not own. (See the Glossary entry for "short position.") Trading account liabilities should be reported at fair value with unrealized gains and losses recognized in current income in a manner similar to trading account assets.

Given the nature of the trading account, transfers into or from the trading category should be rare. Transfers between a trading account and any other account of the bank must be recorded at fair value at the time of the transfer. For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will already have been recognized in earnings and should not be reversed. For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings.

Transaction Account: See "deposits."

Transfers of Financial Assets: The accounting and reporting standards for transfers of financial assets are set forth in ASC Topic 860, Transfers and Servicing (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," as amended by FASB Statement No. 156, "Accounting for Servicing of Financial Assets," FASB Statement No. 166, "Accounting for Transfers of Financial Assets," and certain other standards). Banks must follow ASC Topic 860 for purposes of these reports. ASC Topic 860 limits the circumstances in which a financial asset, or a portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset or when the transferor has continuing involvement with the transferred financial asset. ASC Topic 860 also defines a "participating interest" (which is discussed more fully below) and establishes the accounting and reporting standards for loan participations, syndications, and other transfers of portions of financial assets. A summary of these accounting and reporting standards follows. For further information, see ASC Topic 860.

A financial asset is cash, evidence of an ownership interest in another entity, or a contract that conveys to the bank a contractual right either to receive cash or another financial instrument from another entity or to exchange other financial instruments on potentially favorable terms with another entity. Most of the assets on a bank's balance sheet are financial assets, including balances due from depository institutions, securities, federal funds sold, securities purchased under agreements to resell, loans and lease financing receivables, and interest-only strips receivable.[1] However, servicing assets are not

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[1] ASC Topic 860 defines an interest-only strip receivable as the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Transfers of Financial Assets (cont.):

financial assets. Financial assets also include financial futures contracts, forward contracts, interest rate swaps, interest rate caps, interest rate floors, and certain option contracts.

A transferor is an entity that transfers a financial asset, an interest in a financial asset, or a group of financial assets that it controls to another entity. A transferee is an entity that receives a financial asset, an interest in a financial asset, or a group of financial assets from a transferor.

In determining whether a bank has surrendered control over transferred financial assets, the bank must first consider whether the entity to which the financial assets were transferred would be required to be consolidated by the bank. If it is determined that consolidation would be required by the bank, then the transferred financial assets would not be treated as having been sold in the bank's Reports of Condition and Income even if all of the other provisions listed below are met.[1]

Determining Whether a Transfer Should be Accounted for as a Sale or a Secured Borrowing – A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

(1) The transferred financial assets have been isolated from the transferor, i.e., put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, an entity that is designed to make remote the possibility that it would enter bankruptcy or other receivership (bankruptcy-remote entity) is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it must be consolidated.

(2) Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interest) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.

(3) The transferor, its consolidated affiliates included in the financial statements being presented, or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets. Examples of a transferor's effective control over the transferred financial assets include, but are not limited to (a) an agreement that both entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity, (b) an agreement that provides the transferor with both the unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability, other than through a cleanup call, or (c) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them.

[1] The requirements in ASC Subtopic 810-10, Consolidation – Overall (formerly FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities," as amended by FASB Statement No. 167, "Amendments to FASB Interpretation No. 46(R)"), should be applied to determine when a variable interest entity should be consolidated. For further information, refer to the Glossary entry for "variable interest entity."

Transfers of Financial Assets (cont.):

Financial Assets Subject to Prepayment – Financial assets such as interest-only strips receivable, other beneficial interests, loans, debt securities, and other receivables, but excluding financial instruments that must be accounted for as derivatives, that can contractually be prepaid or otherwise settled in such a way that the holder of the financial asset would not recover substantially all of its recorded investment do not qualify to be accounted for at amortized cost. After their initial recording on the balance sheet, financial assets of this type must be subsequently measured at fair value like available-for-sale securities or trading securities.

Traveler's Letter of Credit: See "letter of credit."

Treasury Receipts: See "coupon stripping, Treasury receipts, and STRIPS."

Treasury Stock: Treasury stock is stock that the bank has issued and subsequently acquired, but that has not been retired or resold. As a general rule, treasury stock, whether carried at cost or at par value, is a deduction from a bank's total equity capital. For purposes of the Reports of Condition and Income, the carrying value of treasury stock should be reported (as a negative number) in Schedule RC, item 26.c, "Other equity capital components."

"Gains" and "losses" on the sale, retirement, or other disposal of treasury stock are not to be reported in Schedule RI, Income Statement, but should be reflected in Schedule RI-A, item 6, "Treasury stock transactions, net." Such gains and losses, as well as the excess of the cost over the par value of treasury stock carried at par, are generally to be treated as adjustments to Schedule RC, item 25, "Surplus."

For further information, see ASC Subtopic 505-30, Equity – Treasury Stock (formerly Accounting Research Bulletin No. 43, Chapter 1, Section B, as amended by APB Opinion No. 6, “Status of Accounting Research Bulletins”).

Troubled Debt Restructurings: The accounting standards for troubled debt restructurings are set forth in ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"). A summary of these accounting standards follows. For further information, see ASC Subtopic 310-40.

A troubled debt restructuring is a restructuring in which a bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. The restructuring of a loan or other debt instrument (hereafter referred to collectively as a "loan") may include, but is not necessarily limited to: (1) the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan (see the Glossary entry for "foreclosed assets" for further information), (2) a modification of the loan terms, such as a reduction of the stated interest rate, principal, or accrued interest or an extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk, or (3) a combination of the above. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not to be reported as a restructured troubled loan.

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

All loans whose terms have been modified in a troubled debt restructuring, including both commercial and retail loans, must be evaluated for impairment under ASC Topic 310, Receivables (formerly FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," as amended). Accordingly, a bank should measure any loss on the restructuring in accordance with the guidance concerning impaired loans set forth in the Glossary entry for "loan impairment." Under ASC Topic 310, when

Troubled Debt Restructurings (cont.):

measuring impairment on a restructured troubled loan using the present value of expected future cash flows method, the cash flows should be discounted at the effective interest rate of the original loan, i.e., before the restructuring. For a residential mortgage loan with a “teaser” or starter rate that is less than the loan’s fully indexed rate, the starter rate is not the original effective interest rate. ASC Topic 310 also permits a bank to aggregate impaired loans that have risk characteristics in common with other impaired loans, such as modified residential mortgage loans that represent troubled debt restructurings, and use historical statistics along with a composite effective interest rate as a means of measuring the impairment of these loans.

See the Glossary entry for "nonaccrual status" for a discussion of the conditions under which a nonaccrual asset which has undergone a troubled debt restructuring (including those that involve a multiple note structure) may be returned to accrual status.

A troubled debt restructuring in which a bank receives physical possession of the borrower's assets, regardless of whether formal foreclosure or repossession proceedings take place, should be accounted for in accordance with ASC Subtopic 310-40. Thus, in such situations, the loan should be treated as if assets have been received in satisfaction of the loan and reported as described in the Glossary entry for "foreclosed assets."

Despite the granting of some type of concession by a bank to a borrower, a troubled debt restructuring may still result in the recorded amount of the loan bearing a market yield, i.e., an effective interest rate that at the time of the restructuring is greater than or equal to the rate that the bank is willing to accept for a new extension of credit with comparable risk. This may arise as a result of reductions in the recorded amount of the loan prior to the restructuring (e.g., by charge-offs). All loans that have undergone troubled debt restructurings and that are in compliance with their modified terms must be reported as restructured loans in Schedule RC-C, part I, Memorandum item 1. However, a restructured loan that is in compliance with its modified terms and yields a market rate need not continue to be reported as a troubled debt restructuring in this memorandum item in calendar years after the year in which the restructuring took place.

A restructuring may include both a modification of terms and the acceptance of property in partial satisfaction of the loan. The accounting for such a restructuring is a two step process. First, the recorded amount of the loan is reduced by the fair value less cost to sell of the property received. Second, the institution should measure any impairment on the remaining recorded balance of the restructured loan in accordance with the guidance concerning impaired loans set forth in ASC Topic 310.

A restructuring may involve the substitution or addition of a new debtor for the original borrower. The treatment of these situations depends upon their substance. Restructurings in which the substitute or additional debtor controls, is controlled by, or is under common control with the original borrower, or performs the custodial function of collecting certain of the original borrower's funds, should be accounted for as modifications of terms. Restructurings in which the substitute or additional debtor does not have a control or custodial relationship with the original borrower should be accounted for as a receipt of a "new" loan in full or partial satisfaction of the original borrower's loan. The "new" loan should be recorded at its fair value.

A credit analysis should be performed for a restructured loan in conjunction with its restructuring to determine its collectibility and estimated credit loss. When available information confirms that a specific restructured loan, or a portion thereof, is uncollectible, the uncollectible amount should be charged off against the allowance for loan and lease losses at the time of the restructuring. As is the case for all loans, the credit quality of restructured loans should be regularly reviewed. The bank should periodically evaluate the collectibility of the restructured loan so as to determine whether any additional amounts should be charged to the allowance for loan and lease losses or, if the restructuring involved an asset other than a loan, to another appropriate account.

Trust Preferred Securities: As bank investments, trust preferred securities are hybrid instruments possessing characteristics typically associated with debt obligations. Although each issue of these securities may involve minor differences in terms, under the basic structure of trust preferred securities a corporate issuer, such as a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the corporate issuer, and trust preferred securities, which are sold to investors. The business trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may also be redeemed under other circumstances. Most trust preferred securities are subject to mandatory redemption upon the repayment of the debentures.

Trust preferred securities meet the definition of a security in ASC Topic 320, Investments-Debt and Equity Securities (formerly FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities"). Because of the mandatory redemption provision in the typical trust preferred security, investments in trust preferred securities would normally be considered debt securities for financial accounting purposes. Accordingly, regardless of the authority under which a bank is permitted to invest in trust preferred securities, banks should report these investments as debt securities for purposes of these reports (unless, based on the specific facts and circumstances of a particular issue of trust preferred securities, the securities would be considered equity rather than debt securities under ASC Topic 320). If not held for trading purposes, an investment in trust preferred securities issued by a single U.S. business trust should be reported in Schedule RC-B, item 6.a, "Other domestic debt securities." If not held for trading purposes, an investment in a structured financial product, such as a collateralized debt obligation, for which the underlying collateral is a pool of trust preferred securities issued by U.S. business trusts should be reported in Schedule RC-B, item 5.b.(1), "Cash instruments," and in the appropriate subitem of Schedule RC-B, Memorandum item 6, "Structured financial products by underlying collateral or reference assets."

U.S. Banks: See "banks, U.S. and foreign."

U.S. Territories and Possessions: United States territories and possessions include American Samoa, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands.

Valuation Allowance: In general, a valuation allowance is an account established against a specific asset category or to recognize a specific liability, with the intent of absorbing some element of estimated loss. Such allowances are created by charges to expense in the Report of Income and those established against asset accounts are netted from the accounts to which they relate for presentation in the Report of Condition. Provisions establishing or augmenting such allowances are to be reported as "Other noninterest expense" except for the provision for loan and lease losses which is reported in a separate, specifically designated income statement item on Schedule RI.

Variable Interest Entity: A variable interest entity (VIE), as described in ASC Subtopic 810-10, Consolidation – Overall (formerly FASB Interpretation No.46 (revised December 2003), "Consolidation of Variable Interest Entities," as amended by FASB Statement No. 167, "Amendments to FASB Interpretation No. 46(R)"), is an entity in which equity investors do not have sufficient equity at risk for that entity to finance its activities without additional subordinated financial support or, as a group, the holders of the equity investment at risk lack one or more of the following three characteristics: (a) the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance, (b) the obligation to absorb the expected losses of the entity, or (c) the right to receive the expected residual returns of the entity.

<u>Variable Interest Entity (cont.):</u>

Variable interests in a VIE are contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests. For example, equity ownership in a VIE would be a variable interest as long as the equity ownership is considered to be at risk of loss.

ASC Subtopic 810-10 provides guidance for determining when a bank or other company must consolidate certain special purposes entities, such as VIEs. Under ASC Subtopic 810-10, a bank must perform a qualitative assessment to determine whether it has a controlling financial interest in a VIE. This must include an assessment of the characteristics of the bank's variable interest or interests and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. The assessment must also consider the entity's purpose and design, including the risks that the entity was designed to create and pass through to its variable interest holders. In making this assessment, only substantive terms, transactions, and arrangements, whether contractual or noncontractual, are to be considered. Any term, transaction, or arrangement that does not have a substantive effect on an entity's status as a VIE, the bank's power over a VIE, or the bank's obligation to absorb losses or its right to receive benefits of the VIE are to be disregarded when applying the provisions of ASC Subtopic 810-10.

If a bank has a controlling financial interest in a VIE, it is deemed to be the primary beneficiary of the VIE and, therefore, must consolidate the VIE. An entity is deemed to have a controlling financial interest in a VIE if it has <u>both</u> of the following characteristics:

- The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance.
- The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

If a bank holds a variable interest in a VIE, it must reassess each reporting period to determine whether it is the primary beneficiary. Based on a bank's reassessment it may be required to consolidate or deconsolidate the VIE if a change in the bank's status as the primary beneficiary has occurred.

ASC Subtopic 810-10 provides guidance on the initial measurement of a VIE that the primary beneficiary must consolidate. For example, if the primary beneficiary and the VIE are not under common control, the initial consolidation of a VIE that is a business is a business combination and must be accounted for in accordance with ASC Topic 805, Business Combinations (formerly FASB Statement No. 141 (revised 2007), "Business Combinations"). If a bank is required to deconsolidate a VIE, it must follow the guidance for deconsolidating subsidiaries in ASC Subtopic 810-10 (formerly FASB Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements").

When a bank is required to consolidate a VIE because it is the primary beneficiary, the standard principles of consolidation apply after initial measurement (see "Rules of Consolidation" in the General Instructions). The assets and liabilities of consolidated VIEs should be reported on the Report of Condition balance sheet (Schedule RC) in the balance sheet category appropriate to the asset or liability. Because Schedule RC does not enable a bank to present separately (a) the assets of a consolidated VIE that can be used only to settle obligations of the consolidated VIE and (b) the liabilities of a consolidated VIE for which creditors do not have recourse to the general credit of the primary beneficiary, a bank that consolidates a VIE may wish to report on such assets and liabilities in the "Optional Narrative Statement Concerning the Amounts Reported in the Reports of Condition and Income."

When-Issued Securities Transactions: Transactions involving securities described as "when-issued" or "when-as-and-if-issued" are, by their nature, conditional, i.e., their completion is contingent upon the issuance of the securities. The accounting for contracts for the purchase or sale of when-issued securities or other securities that do not yet exist is addressed in ASC Topic 815, Derivatives and Hedging (formerly FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by FASB Statement No. 149). Such contracts are excluded from the requirements of ASC Topic 815 as a regular-way security trade only if:

(1) There is no other way to purchase or sell that security;

(2) Delivery of that security and settlement will occur within the shortest period possible for that type of security; and

(3) It is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued.

A contract for the purchase or sale of when-issued securities may qualify for the regular-way security trade exclusion even though the contract permits net settlement or a market mechanism to facilitate net settlement of the contract exists (as described in ASC Topic 815). A bank should document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.

If a when-issued securities contract does not meet the three criteria above, it should be accounted for as a derivative at fair value on the balance sheet (Schedule RC) and reported as a forward contract in Schedule RC-L, item 12.b. Such contracts should be reported on a gross basis on the balance sheet unless the criteria for netting in ASC Subtopic 210-20, Balance Sheet – Offsetting (formerly FASB Interpretation No. 39, “Offsetting of Amounts Related to Certain Contracts”), are met. (See the Glossary entry for "offsetting" for further information.)

If a when-issued securities contract qualifies for the regular-way security trade exclusion, it is not accounted for as a derivative. If the bank accounts for these contracts on a trade-date basis, it should recognize the acquisition or disposition of the when-issued securities on its balance sheet (Schedule RC) at the inception of the contract. If the bank accounts for these contracts on a settlement-date basis, contracts for the purchase of when-issued securities should be reported as "Other off-balance sheet liabilities" in Schedule RC-L, item 9, and contracts for the sale of when-issued securities should be reported as "Other off-balance sheet assets" in Schedule RC-L, item 10, subject to the existing reporting thresholds for these two items.

Trading in when-issued securities normally begins when the U.S. Treasury or some other issuer of securities announces a forthcoming issue. (In some cases, trading may begin in anticipation of such an announcement and should also be reported as described herein.) Since the exact price and terms of the security are unknown before the auction date, trading prior to that date is on a "yield" basis. On the auction date the exact terms and price of the security become known and when-issued trading continues until settlement date, when the securities are delivered and the issuer is paid. If physical delivery is taken on settlement date and settlement date accounting is used, the securities purchased by the bank shall be reported on the balance sheet as held-to-maturity securities in Schedule RC, item 2.a, available-for-sale securities in Schedule RC, item 2.b, or trading assets in Schedule RC, item 5, as appropriate.

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