FFIEC 002 Seminar

P. Drake
B. Goodwin
M. Tursi
P. Maone
H.Castillo
R. Molloy
V. Tovshteyn

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Securities

Peter Drake

Securities

- **FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities"** (FAS 115)
  - FAS 115 establishes standards for accounting for securities

Securities

- Three categories include
  - Held-to-maturity securities
  - Available-for-sale securities
  - Trading securities

Securities

- Held-to-maturity securities
  - Management must have <u>both</u> the positive intent and ability to hold to maturity
  - Carried at **amortized cost** on Schedule RAL, Lines 1.b and 1.c

Securities

– Purchase price adjusted for amortization of premium or accretion of discount if the security was purchased at other than par or face value

– Equity securities cannot be classified as held-to-maturity

Securities

- Available-for-sale securities
  - Securities for which the institution does not have the intent and ability to hold to maturity, yet does not intend to trade actively

Securities

– Reported at **fair value** on Schedule RAL, Lines 1.b and 1.c

– Net unrealized gains and losses in the value of these securities

  - Should be incorporated into the institution's profit/(loss) and reported on Schedule M, Part I, Line 2.a

Securities

- Trading securities
  - Securities purchased and held for sale in the short term or held to gain from changes in short term movement in price
  - Trading securities should be reported at **FV** on Schedule RAL, Line 1.f
  - Gains and losses in the value of these securities should be reported as earnings on Schedule M, Part I, Line 2.a

Securities

- **Some circumstances when the sale or transfer from the held-to-maturity classification is considered consistent with FAS 115**
  - Evidence of a significant deterioration in the issuer's creditworthiness

Securities

– A change in tax law that eliminates or reduces the tax exempt status of interest on the debt security

– A major business combination or major disposition

Securities

- Circumstances when the sale or transfer from the held-to-maturity classification is considered "inconsistent" with FAS 115
  - Changes in foreign currency risk
  - Changes in market interest rates
  - Changes in available alternative investments

Securities

- Changes in funding sources and terms
- Changes in the security's prepayment risk
- Changes in the marginal tax rate
- A liquidity need

Securities

- A **sale or transfer** of a held-to-maturity security for reasons considered inconsistent taints the held-to-maturity portfolio for the remaining held-to-maturity securities for <u>two years</u>

Securities

- As a result, the entire portfolio is considered tainted and the remaining held-to-maturity securities must be reclassified as available-for-sale and reported at fair value

- We recommend any such transfer should be done in **consultation with your external accountants**

Securities

- **Transfers between categories of investments**
  - Transfers of securities between categories are accounted for at fair value on the date of the transfer

Securities

- **Transfer from held-to-maturity to available-for-sale**

Schedule RAL, Line 1.b or 1.c

- Securities reported on RAL, Line 1.b or 1.c will increase or decrease as a result of such a transfer because of the recognition of the gain or loss

Securities

- **Effect of transfer on earnings**
  - The gain or loss at the date of transfer should be reported on Schedule M, Part I, Line 2.a

Reporting of Mortgage-Backed Securities

- **If issued or guaranteed by U.S. Government agencies**
  - reported in Line 1.c.(2) a, if held for investment purposes or
  - reported in Line 1.f.(1), if held for trading

Reporting of Mortgage-Backed Securities

- **Privately issued MBS should be reported as “Other” in**
  – Line 1.c.(2) b, if held for investment purposes or
  – Line 1.f.(2), if held for trading

Commercial Paper Purchased

- Commercial paper (CP) is a short-term, fixed maturity, unsecured promissory note
- Normal maturity is less than 270 days (average 30-50 days) to avoid SEC registration requirements
  - Line 1.c.(4)
  - Line 1.f.(2), if held for trading

Deposit Reporting Issues

Brian Goodwin

Definition of a Deposit

- "A deposit is the unpaid balance of money or its equivalent received or held by a depository institution in the usual course of business and for which it has given or is obligated to give credit either conditionally or unconditionally…"

- "Money received or held by a depository institution or the credit given for money or its equivalent in the usual course of business…"

Deposit vs Borrowing

- In economic terms, deposits and borrowings are similar. However, they are different transactions from a legal and regulatory perspective.

Deposit vs Borrowing

- Determining whether a transaction is a deposit or a borrowing is the reporting institution's responsibility

- If the underlying contractual agreement identifies the item as a deposit or borrowing

- If a transaction is called a deposit it **must be reported as a deposit**

Definitional Differences Between the FFIEC 002 and the FR 2900

- **<u>Affiliates and Subsidiaries</u>**
  - Placements of ***banking affiliates*** and ***subsidiaries*** of the foreign (direct) parent bank should be treated as <u>related</u> on the FFIEC 002 and reported on Schedule M (Due From/Due to Related Institutions in the U.S. and in Foreign Countries)

Definitional Difference Between the FFIEC 002 and the FR 2900

– Placements of affiliates and subsidiaries should be treated as <u>unrelated</u> for the purposes of the FR 2900 Report and reported according to the type of entity (e.g., banking or nonbanking) <u>and</u> maturity of the deposit

Reporting of Customers' Overdrafts

- Customers’ overdrafts should be raised to zero and reported as a loans rather than netted against “good deposit” balances
  - Customers' overdrafts can be categorized as unplanned or planned

Reporting of Customers' Overdrafts

- 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 <u>no advance contractual</u> agreement

Reporting of Customers' Overdrafts

- A planned overdraft is when a contractual agreement has been made in advance to allow such credit extensions.

Reporting of Your Institution's Overdrafts

- Overdrafts on deposit accounts held with other banks (e.g., “due from” accounts)
  - Are to be reported as borrowings on Schedule P, according to the counterparty

Reporting of Overdrafts

Type of Overdraft	Reporting Treatment
Unplanned	Reported as "All other loans" on Schedule C, Line 8 (except for unplanned overdrafts of depository institutions, foreign governments and foreign official institutions, which are reported according to the counterparty)
Planned	Reported as loans on Schedule C according to the counterparty
Your Institution's Overdrafts	Reported as borrowings on Schedule P according to the counterparty

Reporting of Sweep Accounts

- Sweep accounts are agreements:
  - Where funds in excess of a predetermined balance are “swept” into a higher-yielding investment or another deposit account
  - The “swept” balances should be reported based on the nature of the investment and counterparty

Reporting of Sweep Accounts

- Funds are “swept” into another investment (e.g., repurchase agreements)
- The balance swept is not reported on the FFIEC 002 <u>unless the investment is on the balance sheet</u> (e.g., repurchase agreements)

Reporting of Sweep Accounts

- Funds that are swept from a transaction account into a non-transaction account (subject to third party limitations)
  - Report the amount of the “swept” balance on Schedule E, Column C, according to the counterparty

Credit Balances

- Credit balances are special purpose deposits arising out of the exercise of lawful banking powers (e.g., the payment of checks and lending of money)
  - They must be no larger than necessary for the specific transaction
  - Credit balances should be reported on Schedule E, Lines 1- 4, Column A

Cash Collateral

- Cash collateral received (e.g., in connection with loans, letters of credit) should be reported as a deposit
  - The reporting of cash collateral depends on the underlying collateral agreement
  - Cash collateral received can be reported as a transaction or non-transaction account balance on Schedule E

Cash Collateral

- An example of cash collateral would be a commercial letter of credit that is partially or fully collateralized by cash

  -The collateral is reported as a deposit on Schedule E according to the counterparty

  -The non-collateralized portion should be reported on Schedule L, Off-Balance Sheet Items, "Commercial and similar letters of credit", Line 4

Reporting of

Off-Balance Sheet Items

Michael Tursi

Reporting of Off-Balance Balance Sheet Items

- Reporting of derivative contracts
- Reporting of other off-balance sheet commitments and contingencies
- FASB Statement No. 133, "**Accounting for Derivatives Instruments and Hedging Activities**" (FAS 133)

Reporting of Derivative Contracts

- **Balance Sheet Reporting**
  (Schedule RAL)
- **Income Statement Effect**
  (Schedule M, Part I, Line 2.a)
- **Schedule L and M, Part V**
  (Disclosures and Fair Value Examples)

Schedules L and M, Part V Disclosures & Fair Value Examples

Schedules L and M Part V Disclosures

- **Notional Value**
  - Risk characteristics
  - Purpose
- **Fair Values**
  - Risk characteristics
  - Purpose
- **Credit Derivatives**

Schedules L and M, Part V Disclosures & Fair Value Examples

Schedules L and M Part V Disclosures

- Schedule L includes off-balance sheet transactions with **nonrelated** institutions and **related non-depository** institutions

- Schedule M, Part V, includes off-balance sheet transactions with **related depository** institutions

Reporting of Notional Values

- The **notional** value to be reported for an off-balance sheet derivative contract is the underlying <u>principal amount upon which the exchange of funds are based</u>

Reporting of Notional Values

- For example, a swap contract with a stated notional amount of $1,000,000 whose terms call for quarterly settlement of the difference between 5.0% and LIBOR has an effective notional amount of $1,000,000

Reporting of Notional Values

- Contracts with **multiple risk** characteristics should be classified based upon the predominant risk characteristic

- **Report in Line 9 the notional amount** of all outstanding futures and forward contracts, exchange-traded and over-the counter option contracts, and swaps contracts, as appropriate based on the predominant risk characteristic

Reporting of Fair Values

- The definition of “fair value” for the FFIEC 002 purposes is based on FASB Statement No. 107, “**Disclosures About Fair Value of Financial Instruments**” (FAS 107)

Reporting of Fair Values

- FAS 107 defines fair value as "the amount at which the instrument could be exchanged in a current transaction between willing parties, other than a forced liquidation or sale". Report the fair value as follows:
  - If a quoted market price is available for a contract, use closing market price as quoted by the exchange

Reporting of Fair Values

- If a quoted market price is not available, report the bank's best estimate of fair value based on the quoted market price of a similar contract

- When external prices are not available, valuation techniques such as discounted cash flows may be used to establish market values

An Example of Gross Negative Fair Value Calculation

- **Report** in Line 12 **gross positive** and **negative** fair **values** of derivative contracts held for trading and for purposes other than trading.

An Example of Gross Negative Fair Value Calculation

90-day T-Bill Futures Contract $1,000,000

In many cases, the fair value represents the difference between the **current market** price and the **price when the contract was entered into.**

Purchase price	Discount	Settlement price
95.43	4.57	1,000,000 - (4.57% x $1mil) x 90/360 = $988,575

Current price	Discount	Settlement price
95.39	4.61	1,000,000 - (4.61% x $1mil) x 90/360 = $988,475

The gross **negative fair value** = **100**

Current price	$988,475
Purchase price	(988,575)
	($ 100)

An Example of Gross Positive Fair Value Calculation

Forward FX Contract (Purchased)

A gross positive fair value results when the price of the **original contract is less** than the current **price**.

Buy CA$ 1,420,500 (sell US$ 1,000,000)

		Exchange rate CA$/US$
Date of purchase	$1,000,000	1.4205
Report date	1,003,745	1.4152
Change	**$ 3,745**	

Positive fair value

$1,420,500/1.4152 = $1,003,745

$1,003,745 - $1,000,000 = **$3,745**

Reporting of Derivative Contracts on Balance Sheet & "Income Statement"

- The **FV** of derivative contracts held for trading should be reported **gross** (unless FIN 39 applies)
  on Schedule RAL, Line 1.f, "Trading assets"
  or in Line 4.e, "Trading liabilities"

- The gain/loss should be reported as a part of the calculation of unremitted profit/loss on Schedule M, Part I, Line 2.a

Options

Fair value

- For an exchange traded option, the change in the price quoted on the exchange

- For an over the counter option, the change in the price as determined by an option pricing model (e.g., Black-Sholes)

Swaps

Fair Value

- The **fair value** of a swap contract is the net **present value of the future cash flows** (e.g., net settlement amount)
  - Only the net settlement amount should be included in the fair value used to calculate the revaluation gain or loss

Swaps

Fair Value

- Interest accrued but not settled can either be included in the fair value calculation or reported as a separate accrual in trading assets/liabilities if held for trading or other assets/liabilities if held for hedging purposes (methodology must be applied consistently).

Swaps

Swaps held for trading

- The **FV** of these contracts should be reported o Schedule RAL, Line 1.f, "Trading assets" or in Line 4.e, "Trading liabilities"

- The the gain/loss should be reported as part of the calculation of unremitted profit/loss reporte on Schedule M, Part I, in Line 2.a

Swaps

Swaps held for purposes other than trading (e.g., hedging contracts marked-to-market)

- The FV of hedging contracts should be reported on Schedule RAL, Line 1.h, "Other assets" or in Line 4.f, "Other liabilities" and on Schedule M, Part I, in Line 2.a
- These should only include those contracts meeting hedge effectiveness test under FAS 133
- All other contracts should be reported in trading

Reporting of Credit Derivatives

Reporting of credit derivatives is addressed in SR 96-17 (GEN) and FAS 133

- Credit derivatives are off-balance sheet arrangements that allow one party (the "beneficiary") to transfer credit risk of a specific asset to another party (the "guarantor")
  - Allow the beneficiary to mitigate its credit risk concentration to a particular borrower
  - Guarantor assumes the credit risk associated

Reporting of Credit Derivatives

- Certain financial guarantees are not subject to this statement if these provide for payments to the guaranteed party for a loss incurred because the debtor defaults on a payment when payment is due (¶ 10, FAS 133)
  - However, financial guarantees (e.g., credit derivatives) are subject to FAS 133 if the

Reporting of Credit Derivatives

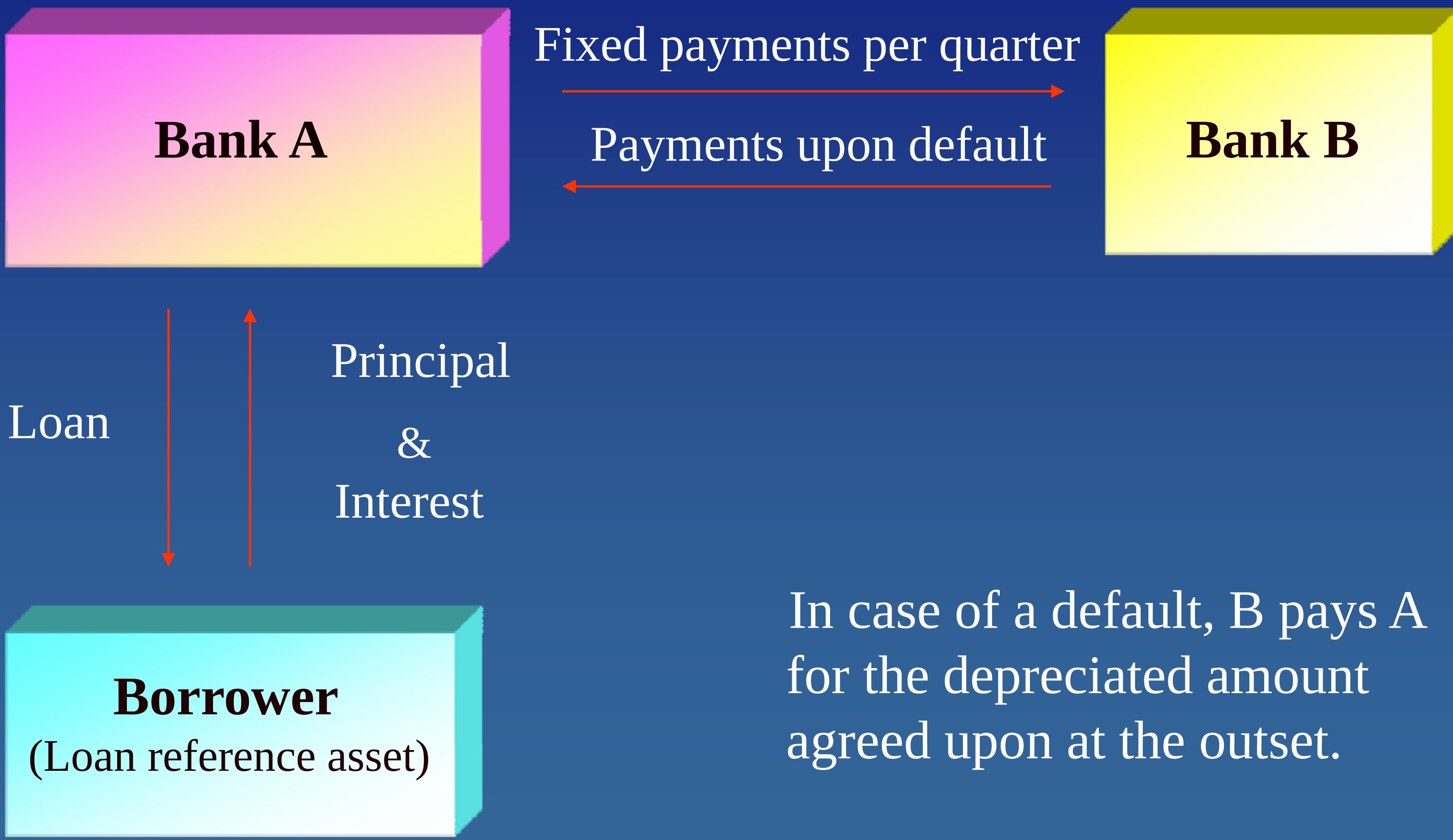
- Credit derivatives subject to FAS 133 should be reported:
  - On the balance sheet in the same manner as any other derivative product
  - Schedule L, Memoranda Section 1 or 2 (Notional amount and fair value disclosures)

Two Common Types of Credit Derivatives

(1) Credit Default Swaps

- The beneficiary agrees to pay guarantor a fixed payment (i.e., a certain number of basis points either quarterly or annually)
- In return the guarantor agrees to pay the beneficiary an agreed upon amount if there is a default

Credit Default Swap Structure



In case of a default, B pays A for the depreciated amount agreed upon at the outset.

Two Common
Types of Credit Derivatives

(2) <u>Total Rate of Return Swaps (TROR)</u>

- The beneficiary agrees to pay the guarantor the
 total return (e.g., principal and interest as well as
 any appreciation in the market value of the asset)

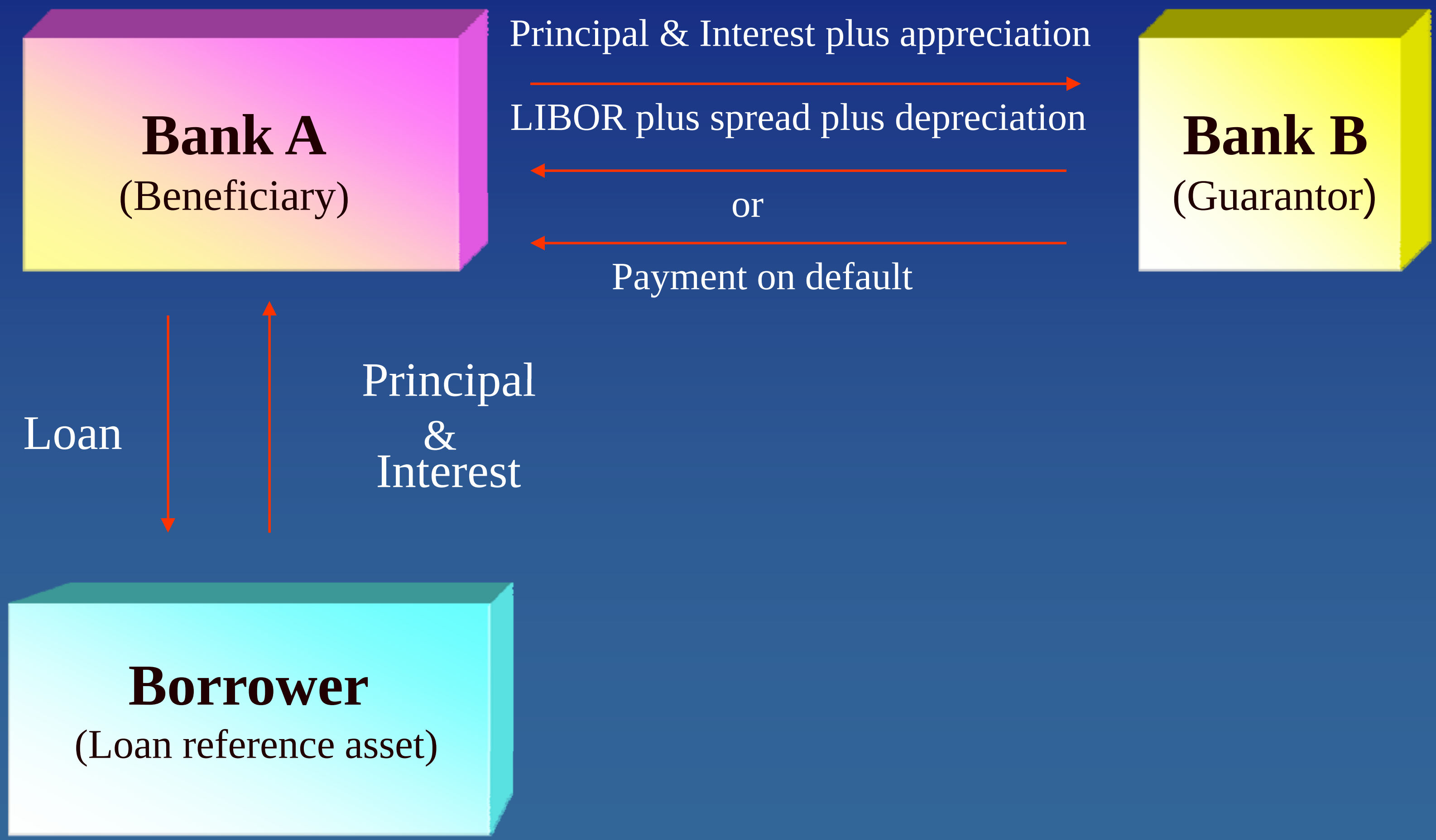
  – The guarantor agrees to pay spread over funding costs plus an depreciation in the value

Two Common
Types of Credit Derivatives

– The guarantor in a TROR could be viewed as having "synthetic ownership" of the asset since it assumes the risks
and rewards of the asset over the agreement period

Total Rate of Return Swaps

Structure

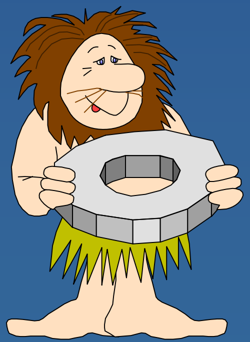


Other Off-Balance Sheet Reporting Issues

- Contingent liabilities, Line 7
  - Commitments to accept and place deposits
  - Purchases and sales of risk participation in loans
  - Securities borrowed
  - Commitments to purchase when-issued securities that are excluded from FAS 133

Other Off-Balance Sheet Reporting Issues

- Contingent Assets, Line 8
  - Securities lent
  - Commitments to sell when-issued securities that are excluded from FAS 133



FAS 133

- **Hedges**
  - The fair value of all non-trading derivatives will be reported on “Other assets” or “Other liabilities”
  - For depository institutions, the two predominate types of hedges are
    - Fair Value
    - Cash Flow

FAS 133

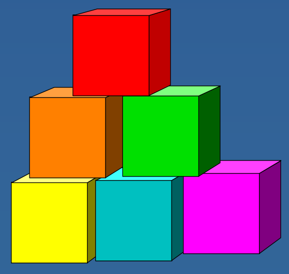
- **Fair Value Hedges**
  - The hedged items are reported at fair value for the portion of the risk being hedged
  - The mark-to-market gains are reported in earnings with the hedging contract
  - To the extent the hedging relationship is effective earning will be uneffected

FAS 133

- **Cash Flow Hedges**
  - Cash Flow Hedges apply to hedging the risk of changes in cash flows for variable rate assets and liabilities

FAS 133

- The difference between a Cash Flow and Fair Value hedge
  - The hedged item is not reported at fair value



FAS 133

- Reporting on the FFIEC 002
  - The mark-to-market gains and losses from fair value and cash flow hedges should be reported in the institution's "Net unremitted profit/(loss)," Schedule M, Part I, Line 2.a

FAS 133

- Inter-company transactions
  – Derivatives with the parent bank or another
  office of the reporting branch's or agency's parent bank may <u>qualify for hedge accounting provided</u>

______ The counterparty (e.g., the other member of the consolidated group) has entered into a contract with an unrelated party that offsets

FASB Interpretation No. 46

Mike Tursi

FASB Interpretation No. 46

- Requires consolidation of variable interest entities ("VIEs") by enterprises that have controlling financial interest.
- VIEs are special purpose entities ("SPEs") where either of the following conditions exist:
  - Total equity at risk is not sufficient to cover expected losses
  - Holders of equity at risk:
    - Lack ability to make decisions about the entity's activities
    - Lack obligation to absorb expected losses or receive residual gains.

FASB Interpretation No. 46

- Enterprise that has a variable interest or combination of variable interests that will absorb a majority of the VIE's expected losses or receive a majority of the VIE's expected residual returns is the VIE's **primary beneficiary**.

- The **primary beneficiary** is the equivalent of the accounting parent and thus consolidates the VIE.

FASB Interpretation No. 46

- Variable interests are contractual, ownership, or other financial interests in a VIE that changes with the VIE's net asset value (e.g., equity interest, loans or debt securities, guarantees)

- An equity investment of less than 10% is presumed to be insufficient to finance a VIE's activities.

FIN 46(R) - Effective Date and Transition

- Enterprises shall disclose the following interim information before adopting FIN 46(R) in all financial statements initially issued after December 31, 2003, regardless of the date on which the VIE was created:

  a) The nature, purpose, size, and activities of the VIE

  b) The enterprise's maximum exposure to loss as a result of its involvement with the VIE

FIN 46(R) - Effective Date and Transition

- A public entity that is not a small business issuer - no later than the end of the first reporting period that ends after March 15, 2004.
- A public entity that is a small business issuer - no later than the end of the first reporting period that ends after December 15, 2004.
- A nonpublic entity, that has VIEs created after December 31, 2003, shall apply FIN 46 immediately.
- A nonpublic entity shall apply FIN 46 to all entities by the beginning of the first annual period beginning after December 15, 2004.

FIN 46(R) - Effective Date and Transition

- A public entity is any entity:

  a) Whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally,

  b) That makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or

  c) That is controlled by an entity covered by (a) or (b) above.

FIN 46(R) - Effective Date and Transition

- A foreign branch or agency is considered a U.S. public company if its parent bank's equity securities are traded in a public market either on a ***U.S. stock exchange*** or in the ***over-the-counter market***, including securities quoted only ***locally or regionally***.

FIN 46(R) - Mutual Funds/Trust Arrangements

- Exception provided to mutual funds in the form of trusts and trusts of a bank's trust department unless used by the enterprise to circumvent FIN 46(R).

FIN 46(R) - Design of Ownership Changes

- Whenever the design of an entity or ownership interests change, the determination of VIE status must be reconsidered.

FIN 46(R) - Recognition of Goodwill

- Requires that an enterprise recognize goodwill if it becomes the primary beneficiary of a VIE that is a business.

Definition of a Subsidiary

- For the purposes of defining the nonbank subsidiary reports the Regulation Y definition of subsidiary is used.
- As defined by 225.2 of Regulation Y, a subsidiary generally includes:
  - Companies 25% or more owned or controlled by another company
  - Companies that control in any manner the election of a majority of the Board of Directors of another company
  - Companies that have a controlling interest over another company.
- Controlling interest used in FIN 46 is generally defined in terms of non-voting interest, which is not covered in Reg Y’s definition of a subsidiary.

FFIEC 002 Report Instructions - Initial Measurement

- The primary beneficiary should follow the guidance specified in paragraphs 43, 44 and 45 of FAS 141, *Business Combinations*, when consolidating the VIE, as if the initial consolidation had resulted from a business combination.
  - Excess of the fair value of newly consolidated assets over consideration paid should be reported as a pro rata adjustment to amounts assigned to newly consolidated long-term assets. If any excess remains after reducing the long-term assets to zero, it should be reported as an extraordinary item.
  - Excess of the consideration paid and other factors over the fair value of the newly consolidated assets is to be reported as goodwill in the period in which the enterprise becomes a primary beneficiary.

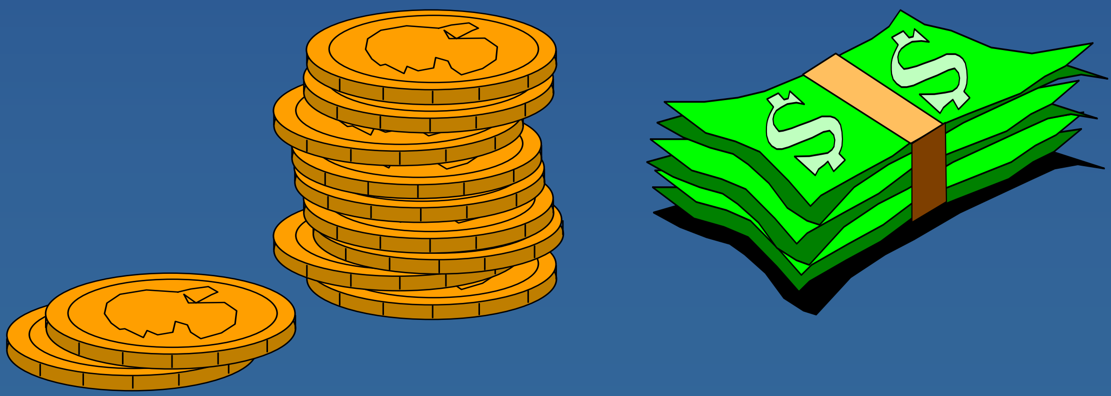
FFIEC 002 Report Instructions

- Line-by-line consolidation (asset and liabilities accounts are reported as part of the bank in the same manner if the conduit was reported as a separate entity, equity and intercompany accounts are eliminated in consolidation).

Loans

Allowances for Loans, Leases and Credit Losses

Patricia Maone



Loans

Objectives

- Unamortized loan fees
- Loans held for sale
- Specific and General Reserves
- Charge-offs and Recoveries
- Allowance for credit losses

Loans

- Report the amortized cost of all loans and leases (unless they are being hedged using FV hedge accounting or are held for sale) before deducting the allowance for loan and lease losses on Schedule C

- Loans should be reported <u>net</u> of:

  1. Unearned income
  2. Specific reserves
  3. Unamortized loan fees

Loans

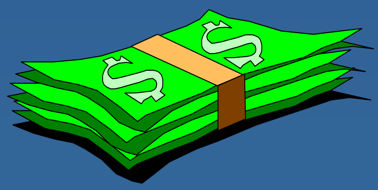
- Loans and leases held for trading purposes are reported as "Trading assets" at **fair value** on Schedule RAL in Line 1.f

- Loans held for sale should be reported **at the lower of cost or fair** value on Schedule C (SR Letter 01-12)

Fees on Loans

- Net unamortized fees on loans are
 reported in the same manner as
unearned
 income on loans (e.g., deducted)

- Net unamortized direct loan origination
 costs are added to the related loan
balances
 and reported in each line as
appropriate



General Allowance for Loan Loss ("General Reserves")

- Branches and agencies are not required to hold general reserves at the branch or agency level (SR Letter 95-4)

- Loans are reported on Schedule C (and throughout the report) at their **book value** and may not be reduced by the amount of general reserves

General Reserves

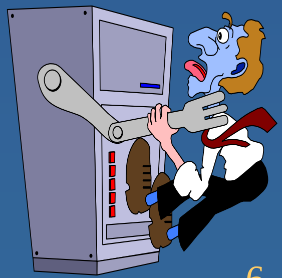
- General reserves may still be maintained by an institution as part of its internal credit policy
  - General allowance for loan losses represents reserves that are maintained against the loan portfolio in order to absorb probable losses

General Reserves

Accounting Entries

Dr Provision for Loan Losses
(Expense)

Cr Allowance for Loan Losses
(Contra-asset)



General Reserves

- Report **gross** on **<u>Schedule M, Part I</u>**, Line 2.a, Column B, as "**due to**" and <u>not netted</u> against loans reported on Schedule C

- Also report on the **<u>Schedule M, Part IV</u>**, Line 1

Specific Allowance for Loan Losses
("Specific Reserves")

- If an **identified loss exists**, the amount of the loss should be charged-off or a specific reserve should be established against the loan
  - Specific loan loss reserves are only maintained for identified losses

Specific Reserves

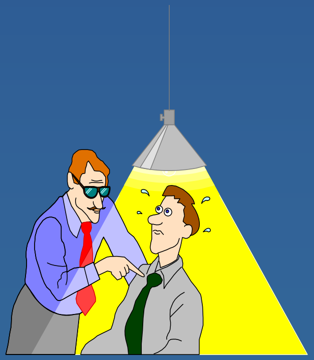
- A full or partial write-down of a loan through a direct charge off, cannot be reversed at a later date (e.g., the cost basis cannot be “written-up”)

Specific Reserves

Accounting Entries

Dr Provision for Loan Losses
(Expense)

Cr Specific Reserve for Loan Losses
(Contra-asset)



Specific Reserves

- The provision for specific loan loss reserv is reported on the FFIEC 002 in the same manner as the provision for general loan loss reserves on Schedule M, Part I, in Line 2.a
- Loans should be reported net of identified losses on Schedule C (and throughout the report)

General vs Specific Reserves
Accounting Entries

General Reserves

Dr Provision for Loan Losses ***(M, Part I, Line 2.a, Col A)***

Cr Allowance for Loan Losses
(M, Part I, 2.a, Col B; M, Part IV, Line 1)

Specific Reserves

Dr Provision for Loan Losses ***(M, Part I, Line 2.a, Col A)***

Cr Specific Reserves for Loan Losses
(Deducted from a specific loan on Schedule C)

Charge-Off of a Loan for Which a General Reserve was Established

"Allowance Method"

- **When a Loan is Deemed Uncollectible**

1. <u>Reduce the amount of loan</u>

Dr Allowance for Loan Losses (Contra-asset)
Cr Loan (Asset)

2. <u>Record uncollectible amount</u>

Dr Uncollectible Accounts (Expense)
Cr Provision for Loan Losses (Expense)

Recovery of a Loan for Which a General Reserve was Established

"Allowance Method"

- **When a Loan Previously Charged-off is Collected** (e.g., partially or fully)

1. Record the Recovery

Dr Cash (Amount recovered)

Cr Uncollectible Accounts (Expense)

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2. Reverse the Allowance

Dr Provision for Loan Losses (To replenish reserve)

Cr Allowance for Loan Losses
(To replenish allowance)

Direct Charge-Off Method

- If a depository institution identifies a loss amount for a particular loan and wishes to charge the loan off directly in lieu of a specific reserve it may do so via the following entry:

Dr	Expense
Cr	Loan

- The loss is charged against income (reduction to unremitted profit) on Schedule M, Part I, Line 2.a. The individual loan balance is reduced by the amount of the charge-off on Schedule C.

Recovery

"Direct Charge-Off Method"

- A recovery for a loan that was **charged-off directly** should be accounted for as follows:

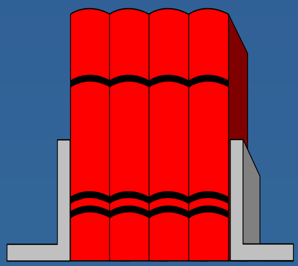
Dr Cash (Amount recovered)

Cr Expense (Amount recovered)

  – The recovered amount is reflected in the cash account and the expense incurred by the direct write-off is reversed

Allowances for Credit Losses

- The AICPA's Audit Guide for Banks and Savings Institutions requires the allocation on the balance sheet of the allowance for credit losses



Allowances for Credit Losses

- Portions of the allowance related to trading assets should be reported in "Trading assets" on Schedule RAL in Line 1.f
- Portions of the allowance related to off balance-sheet credit commitments should be reported in "Other liabilities" on Schedule RAL in Line 4.f

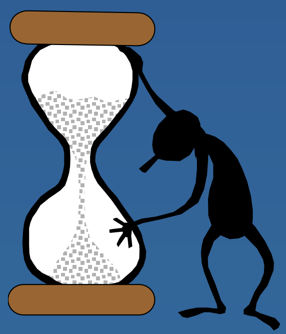
Note: Since derivative products are reported at fair value, the credit reserve is part of the fair value reported on the balance sheet

Allowance for Credit Losses

- Allowance for credit losses is created to cover <u>counterparty risk only</u>
  - A separate valuation reserve is established to cover <u>market losses</u> associated with the trading account and should be excluded from credit reserves.

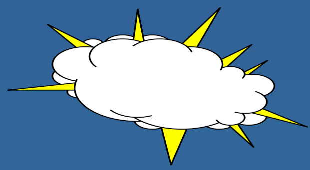
Key Points

- Loans should be reported at:
  - Amortized cost, except under FV hedge accounting or if held-for-sale
  - Net of specific reserves
  - Gross of general allowance
  - Net of unearned income
  - Net of unamortized loan fees
- Yield-adjustment fees vs loan servicing fees



Key Points

- Loans held for sale
- Specific reserves
- “Allowance” vs direct “charge-off” method
- Allowance for off-balance sheet items



Lunch Break!

Reporting Issues

Henry Castillo

Offsetting

- Financial Accounting Standards Board Interpretation No. 39 (FIN 39)
  - Allows offsetting of certain contracts when a “right of setoff” exists

Offsetting

FIN 39 Offsetting Criteria

- There are two parties to the transaction, each owes the other determinable amounts
- Reporting party has the right to set off the amount owed by the other
- Reporting party intends to set off
- Right of setoff is enforceable by law

Offsetting Under Master Netting Agreement

- Fair value of derivative contracts reported on the balance sheet that fall under a contractual agreement providing for the net settlement through a single payment can be reported net under FIN 39

Offsetting

- **Financial Accounting Standards Board Interpretation No. 41 (FIN 41)**
  - Allows netting of repurchase and reverse repurchase agreements that meet the legal right of setoff

Offsetting

FIN 41 Offsetting Criteria

- Agreements executed with same counterparty
- Have same explicit settlement date at inception of agreement
- Executed in accordance with a Master Netting Agreement

Offsetting

FIN 41 Offsetting Criteria

- Securities underlying the agreements exist in "book entry" form
- Agreements are settled on a securities transfer system

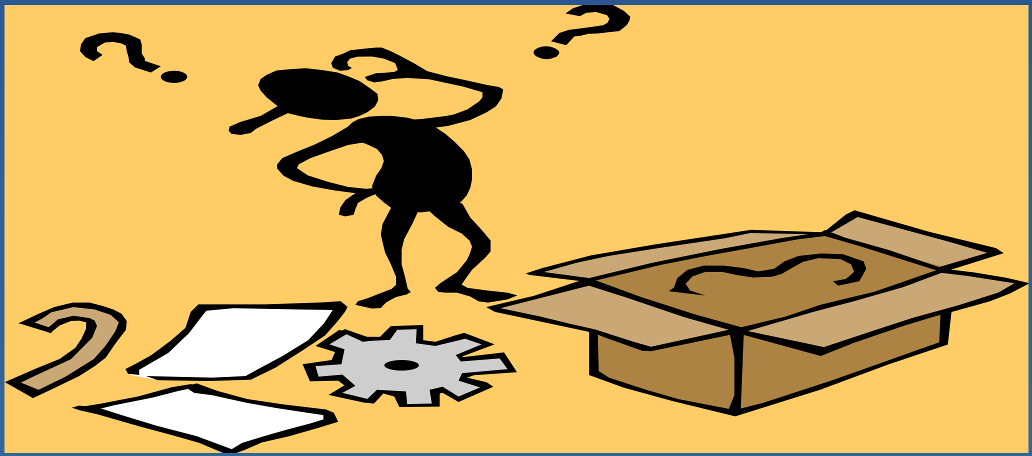
Offsetting

FIN 41 Offsetting Criteria

- Institutions intend to use same account at clearing bank for cash inflows and cash outflows resulting from settlement of these agreements

Reporting of

Repurchase & Reverse Repurchase Agreements



Reporting of Repurchase & Reverse Repurchase Agreements

- **FAS 140, "<u>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</u>"**

  <u>Defines a transfer of an asset as</u>:

  – Transferred assets must be isolated from the transferors and creditors even in bankruptcy

  – Transferee (purchaser) must be able to repledge or exchange the asset

  – Transferor is not <u>obligated</u> to repurchase or redeem the transferred asset

Reporting of Repurchase & Reverse Repurchase Agreements

- If a repurchase agreement does not meet the sale criteria in ¶ 9 of FAS 140, the transaction qualifies as a financing transaction and there is no change in reporting
  - Repurchase agreements are reported on Schedule RAL, Line 4.b (2)
  - Reverse repurchase agreements are

Reporting of Repurchase & Reverse Repurchase Agreements

- The reporting of repurchase agreements and reverse repurchase agreements depend on whether:
  - The transferor has the right and ability to redeem the securities on short notice
  - The transferee has the right to sell or repledge the security

Reporting of Repurchase & Reverse Repurchase Agreements

- If the control of the collateral is transferred in accordance with ¶ 15 of FAS 140
  - Except as provided in ¶ 15.c, the debtor or transferor of securities shall continue to carry the collateral as its asset; the secured party or transfer shall not recognize the pledged asset

Reporting of Repurchase & Reverse Repurchase Agreements

Borrower's accounting entries

Dr Cash

Cr Repurchase Agreemen

Reporting of Repurchase & Reverse Repurchase Agreements

Lender's accounting entries

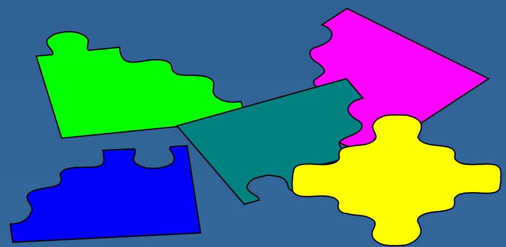
Dr Reverse Repurchase Agreements

Cr Cash

Reporting of Equity Investments

Reporting of Equity Investments

- The amount of influence an institution has over the operations of the entity whose stock it owns determines the accounting method to be applied in reporting the investment



Reporting of Equity Investments

- **Methods of Accounting of Long-Term Investments**
  - Cost Method
  - Equity Method
  - Consolidation Method

Reporting of Equity Investments

Cost Method

- Equity Investments that Represent less than 20% Ownership in a Company
  - Subject to FAS 115
  - If Available-for-sale, report at fair value on Schedule RAL, Line 1.c
  - If Trading, report at fair value on Schedule RAL, Line 1.f

Reporting of Equity Investments

Equity Method

- Equity Investments that Represent 20 - 50% Ownership in a Company
  - Not subject to FAS 115

Reporting of Equity Investments

Equity Method

- The carrying value of the bank's investment in a company is originally recorded at cost but is adjusted periodically
  - To record share of institution's earnings or losses in income
  - To record any cash dividends received

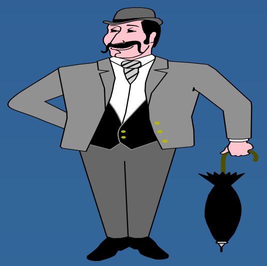
Reporting of Equity Investments

Equity Method

- *Original Entry*

Dr Investment in ABC Sub (Other assets)

Cr Cash



Reporting of Equity Investments

Equity Method

- *To Record Net Income received from Sub*

Dr Investment in ABC Sub (Other Assets)

Cr Income

- *To record Receipt of Dividends*

Dr Cash

Cr Investment in ABC Sub

Reporting of Equity Investments

Consolidation Method

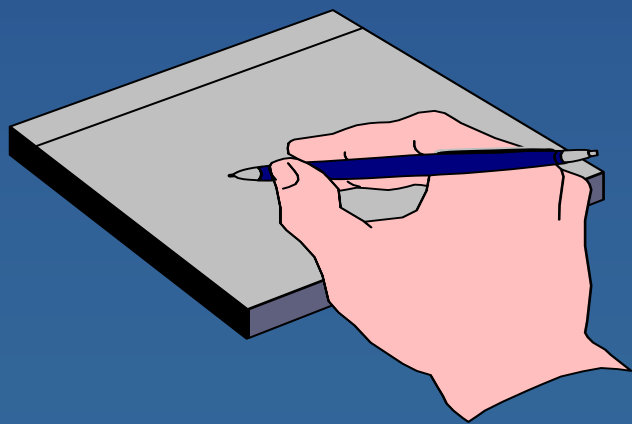
- Equity securities that represent more than 50% ownership in a company
  - Not subject to FAS 115
  - Consolidated on a line-by-line basis
    - Must consolidate the entire entity rather than only the percentage owned

Summary Chart

Level of Control	Indication	Recording Investment at Purchase	Method of Recording Subsequent to Purchase	FAS 115
Investor can exert absolute control over the activities of the entity	**Over 50%** ownership	Recorded at Original Cost	**Consolidation**	Does not Apply
Investor can exercise significant influence but not absolute control, in general	**20% - 50%** ownership	Recorded at Original Cost	**Equity Method**	Does Not Apply
Investor cannot exercise control or significant influence	**Less than 20%** ownership	Recorded at Fair Value	**Cost Method**	Applies

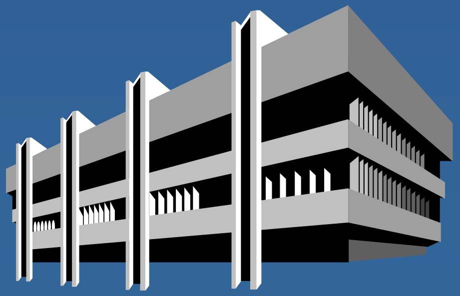
Reporting of

Other Assets and Other Liabilities



Reporting of Other Assets

- All fixed assets should be reported at book value (i.e., original cost less accumulated depreciation)
- Precious metals inventories



Reporting of Other Assets

- In-substance foreclosures (ISFs) should be reported as loans until the lender has taken possession (e.g., loan title or control) of collateral
  - Once possession is taken, the fair value of the collateral should be reported as OREO

Reporting of Other Assets

- Income earned or accrued but not collected on loans, securities, and other interest-bearing assets should be reported in other assets.
- Customers' liability for deferred payment letter of credit

Reporting of Other Assets

- Cash balances held in margin accounts regardless of purpose of the underlying transaction

- Positive fair value (FV) of derivative contracts designated as hedges under FAS 133

Reporting of Other Liabilities

- All accounts payable should be reported gross in other liabilities and should not to be netted against accounts receivable
- Interest accrued and unpaid on deposits

Reporting of Other Liabilities

- Bank's liability for deferred payment letters of credit
- Negative FV of derivative contracts designated as hedges under FAS 133

Reporting of Suspense Accounts

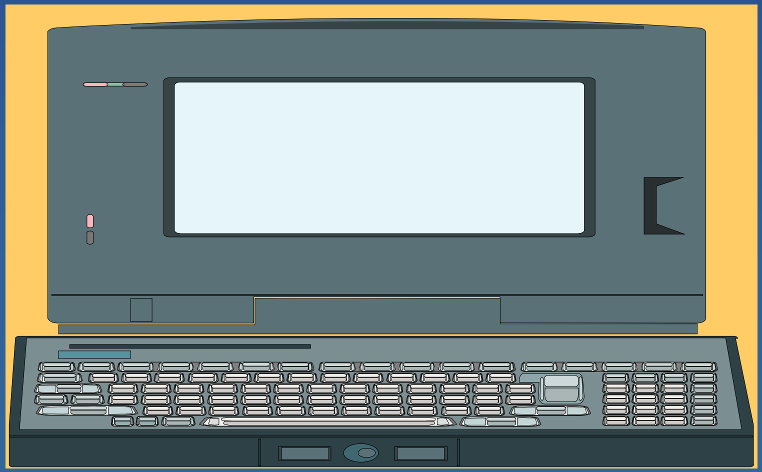
- Suspense accounts
  - **Temporary holding accounts** where items are carried until they can be identified and posted to the proper account

Reporting of Suspense Accounts

- Suspense accounts should be reviewed prior to the submission of the FFIEC 002 and reported in the appropriate account

Electronic

Submission



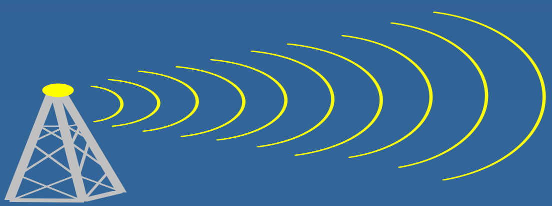
Electronic Submission

- Benefits of electronic submission
  - More time to prepare the report
  - Allows filing up to 5:00 p.m. on due date
- Internet

Website

- The FFIEC 002 form, presentations and transmittal letters are available at:

http://www.newyorkfed.org/banking/reportingforms/FFIEC_002.html



Reporting of Securitization and Asset Sale Activities

Rich Molloy

Schedule S
Securitization and Asset Sale Activities

- Overview
  - Credit exposure and liquidity for assets SOLD and SECURITIZED by the reporting institution.
  - Credit exposure and liquidity to securitization structures sponsored by others.
  - Credit exposure to assets sold by the reporting institution but not securitized.

Schedule S
Securitization and Asset Sale Activities

- Assets sold and securitized by reporting institution
  - Line items 1. through 7.b.
- Credit Exposure to Securitizations Sponsored by Others
  - Credit exposure, Line 9.
  - Unused commitments, Line 10.

Schedule S
Securitization and Asset Sale Activities

- Assets sold and not securitized by the reporting institution
  - Line 11. and Line 12.
- Memoranda - Asset-backed Commercial Paper Conduits
  - Memorandum
    - Line Items M 1.a.(1) and M 1.b.(1)
    - Line items M 1.a.(2), M 1.b.(2)

Schedule S
Securitization and Asset Sale Activities

- Data will be collected on the following loans in a column format:
  - Residential Mortgages — Column A
  - Home Equity Loans — Column B
  - Credit Card Receivables — Column C
  - Auto Loans — Column D
  - Other Consumer Loans — Column E
  - Commercial and Industrial Loans — Column F
  - All Other Loans and All Leases — Column G

Item 1

<u>Outstanding principle balance of *assets sold* and securitized with *servicing retained* or with *recourse* or other seller-provided *credit enhancements*</u>

- Report any retained risk (in form or substance) of credit loss in the securitized assets
- Report obligations to repurchase assets that do not perform
- Report representations or warranties to absorb credit losses on transferred assets

Item 1

- Assets sold that do not meet FAS 140's criteria for sale accounting or that must be consolidated on the reporting institution's financial statements based on FIN 46 should not be reported on Schedule S.
  - *Note: Credit enhancements and liquidity commitments to ABCP conduits ARE included in the memo section.*

Item 2

Maximum amount of *credit exposure* arising from *recourse* or other seller-provided *credit enhancements* provided to structures reported in Item 1

- The maximum contractual credit exposure remaining as of the report date from obligations reported in Item 1.
- **Item 2.a.** **-** Interest only strips or excess spread accounts

Item 2

Maximum amount of *credit exposure* arising from *recourse* or other seller-provided *credit enhancements* provided to structures reported in Item 1

- **Item 2.b. -Subordinated securities and other residual interest:**
  - Recourse Obligations, Subordinated Interests
  - Spread Accounts, Cash Collateral Accounts
  - Collateral Invested Amounts, Over collateralization
- **Item 2.c. - Standby letters of credit and other enhancements**
  - Credit Derivatives

Item 3

<u>Reporting bank's *unused commitments* to provide liquidity structures reported in Item 1</u>

- Liquidity facilities
- Servicer cash advance

Item 4

Past due loan amounts included in Item 1

- The outstanding principal balance of any loans and leases reported in item 1 that are past due 30-89 days are reported in item 4.a and those more than 90 days past due are reported in item 4.b.
- Use past due instructions for Schedule N

Item 6

Amount of ownership (or seller's) interest carried as securities or loans

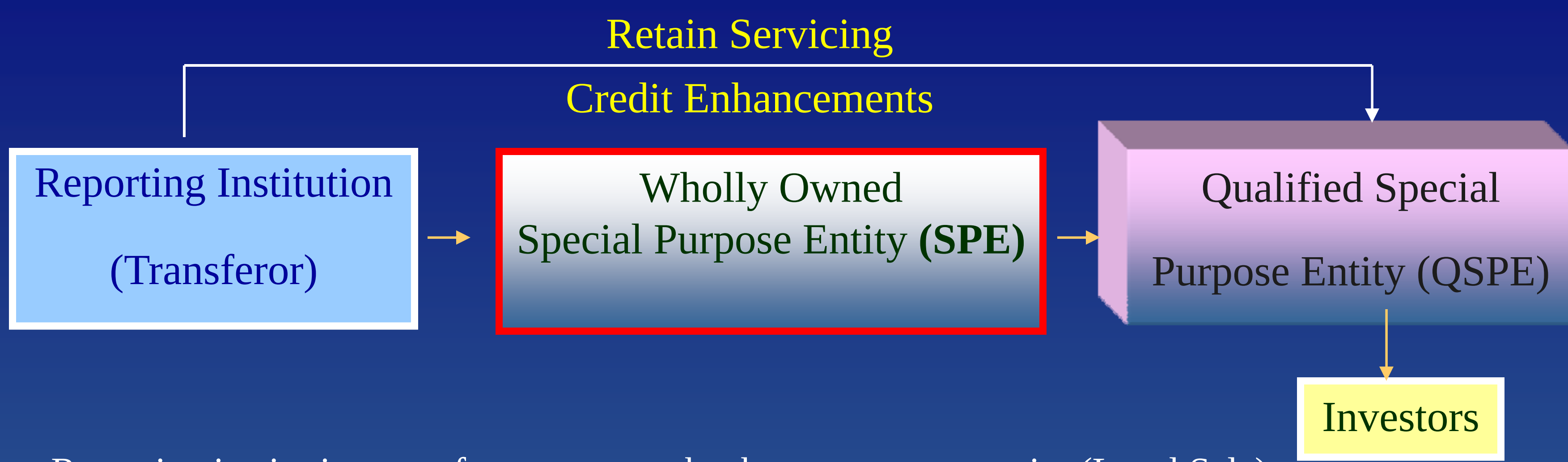
- For home equity lines (Column B), credit card receivables (Column C) and commercial and industrial loans (Column F) reported in Item 1.
  - Report all interests in the form or securities in Line 6.a. (also reported in Schedule RAL, Line 1.c and Line 1.f)
  - Report all interests in the form of loans in Line 6.b (also reported in Schedule C, Line 8)

Item 7

Past due loan amounts included in interests reported in Item 6

- The outstanding principal balance of any loans and leases reported in item 6 that are past due 30 -89 days are reported in item 7.a. and those that are more than 90 days past due are reported in item 7.b.
- Use past due instructions for Schedule N

Assets Sold and Securitized (Items 1-7)



1. Reporting institution transfers assets to a bankruptcy remote entity (Legal Sale)
2. The SPE transfers the Qualified Special Purpose Entity (QSPE) (Accounting Sale)
3. QSPE obtains credit enhancements and issues asset-backed securities to investors

- If reporting institution retains servicing, report on Schedule S item 1
- If reporting institution provides credit enhancements or liquidity to the securitization structure, report on Schedule S item 1 and items 2-7 based on the type of credit enhancement or liquidity provided.

Item 9

Maximum amount of credit exposure arising from *credit enhancements* provided by the reporting bank to other institutions' securitization structures in the form of *standby letters of credit*, purchased *subordinated securities* and other credit enhancements

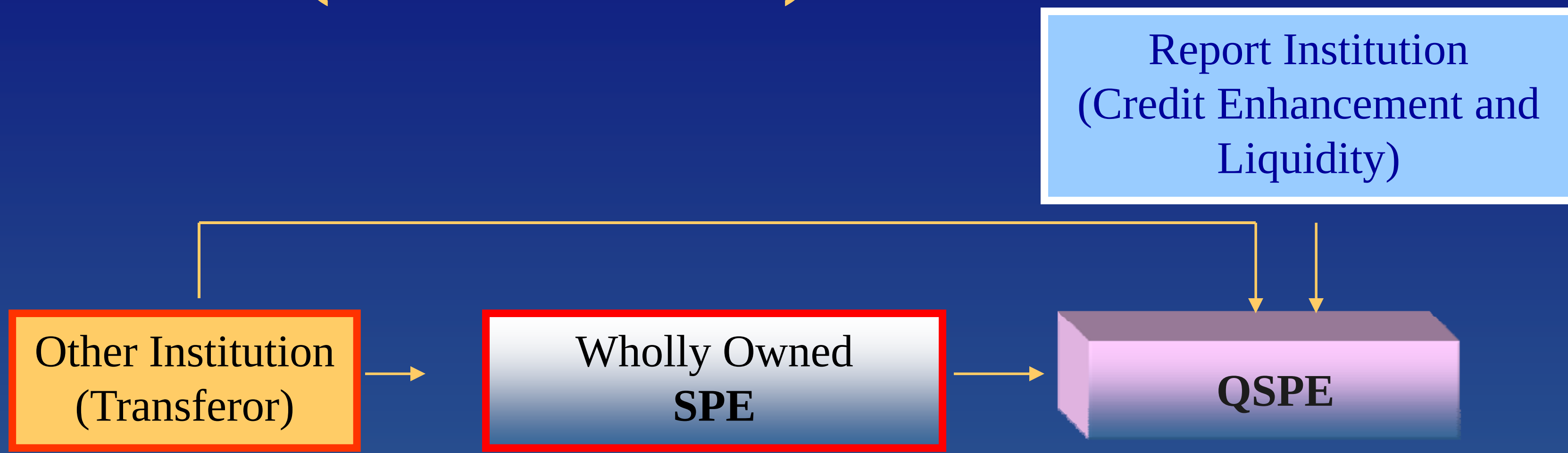
- Include all credit enhancements to third parties (foreign and domestic banks, insurance companies, investment banks).
- Exclude those provided to other institutions' asset-backed commercial paper programs (reported in Memorandum, Item 1).

Item 10

Reporting bank's *unused commitments* to provide *liquidity* to other institutions' securitization structures

- Report in the appropriate Column the unused portions of the liquidity commitments to third party securitization structures
- Such securitizations would not be reported in Item 1

Credit Enhancement/Liquidity to Others (Items 9-10)



1. Reporting institution provides credit enhancements to QSPE.

   • The reporting institution reports the credit enhancement or liquidity on Schedule S items 9 -10 based on credit enhancement or liquidity is provided.

   • Do not include credit enhancements or liquidity to asset-backed CP conduit.

Items 11

<u>Assets *sold with recourse* or other seller-provided credit enhancements and not securitized</u>

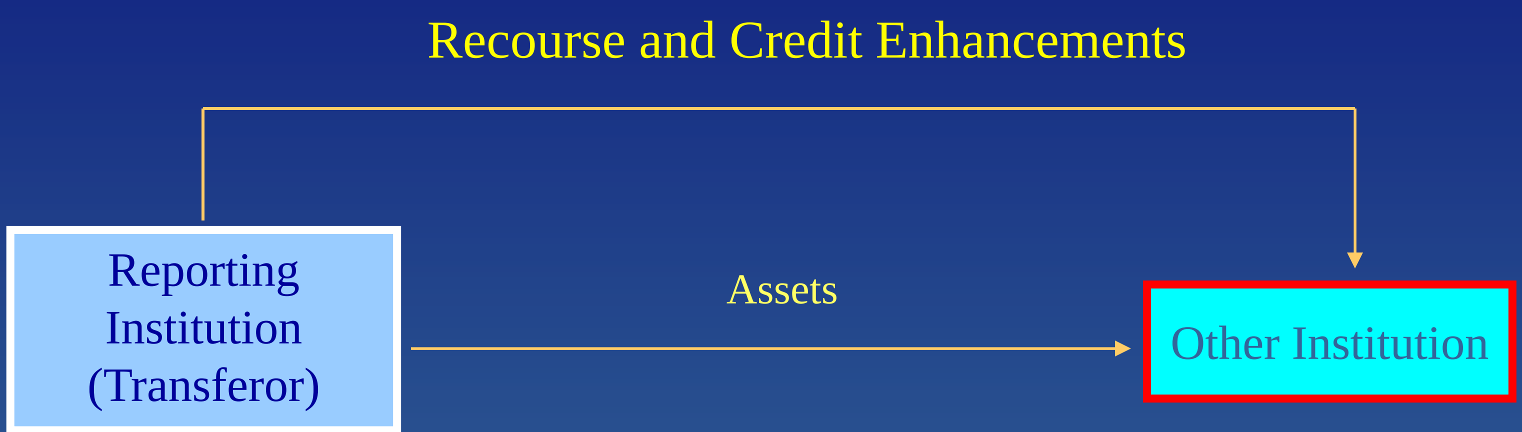
- Report the unpaid principal balance of loan and leases sold with recourse or other seller-provided credit enhancement but have not securitized

Item 12

Maximum amount or credit exposure **arising from recourse or other seller-provided credit enhancements provided to assets reported in Item 11**

- Report the unused portion of standby letters of credit, the carrying value of retained interests, and the maximum amount of credit exposure from recourse and other credit enhancements

Asset Sales (Items 11-12)



1 . Reporting institution sells assets to another institution.

2. If the reporting institution retains recourse or provides credit enhancements, the amount of the outstanding principal balance is reported on Schedule S item 11.

3. The maximum amount of the credit exposure due to credit enhancements or recourse is reported on Schedule S item 12.

Memorandum Item 1

Asset-backed commercial paper conduits

- Maximum amount of credit exposure arising from credit enhancements provided to conduit structures in the forms of standby letters of credit, subordinated securities and other credit enhancements.
- Unused commitments provided to conduit structures
- Report according to entity type sponsoring the conduit

Commercial Paper Conduits - Memorandum Section

Reporting Institution (Sponsor)

Credit Enhancement and/or Liquidity Lines ABCP

Asset Seller → Wholly Owned **SPE** → CP Conduit

Issues ABCP

Investors

1. Asset Seller transfers assets to a bankruptcy remote entity (Legal Sale)
2. The SPE transfers the QSPE (CP) Conduit (Accounting Sale)
3. Conduit obtains credit enhancements and liquidity commitments from reporting institution and issues ABCP to investors.
   - Credit enhancements supporting the investors against defaults on the CP are reported in Memorandum section item M(1)(a)(1).
   - Unused liquidity lines (used to provide funds to smooth out payment flows) for the CP are reported in Memorandum section item M(1)(b)(1)).

Commercial Paper Conduits - Memorandum Section

Other Institution (Sponsor) → Wholly Owned **SPE** → CP Conduit (Issues ABCP)

Reporting Institution

Credit Enhancement and Liquidity Lines

Investors

Conduit obtains credit enhancements and/or liquidity commitments from reporting institution and issues asset-backed CP to investors.

- Credit enhancements supporting the investors against defaults on the commercial paper are reported in Memorandum section item M(1)(a)(2).
- Unused liquidity lines (ex. used to provide funds to smooth out payment flows) for the CP are reported in Memorandum section item M(1)(b)(2)).

Income Statement

Reporting Issues

Vadim Tovshteyn

Income Statement Issues

- FFIEC 002 Report does not contain income statement
- However, unremitted profits/losses are reported on Schedule M, Part I, Line 2.a
- How to report the income statement and other similar items on the FFIEC 002?

Income Statement

\+ Interest income
\- Interest expense
= **Net Interest Income**
\- <u>Provision for Loan Losses</u>
= **<u>Net Interest Income</u>** (net of provision)
± Non Interest Income (includes net gain/(loss) on F/X and trading account)
\- Non Interest Expense
± <u>Extraordinary Items</u>
= **<u>Net Profit or Loss</u>**

Income Statement Issues

- Provision
  - The provision for <u>both specific and general reserves</u> is an expense and should be reported on Schedule M, Part I, Line 2.a as part of t profit/(loss) calculation

Income Statement Issues

- Net unrealized gains or losses on the available-for-sale securities should be reported as part of unremitted profit (loss) on Schedule M, Part I, Line 2.a

- U.S. income tax expense and income tax payable should be **excluded** from the FFIEC 002

Income Statement Issues

- The IBF’s net profit or loss
  - Report in Part II, Line 1.b (1) (When maintained as a separate account)
  - In addition, consolidate with the bank’s profit or loss and report on Schedule M, Part I, Line 2.a

Income Statement Issues

- The mark-to-market gains and losses from fair value and cash flow hedges should be reported as components of the "Net unremitted profit/(loss)," Schedule M, Part I, Line 2.a

<u>Example 1</u> - Problem

- *Capital Contribution* = ***50 mil***
- Net Profit - Branch = **(20 mil)**
- Net Unrealized <u>Loss</u> on AFS Sec = **(26 mil)**
- What is reported in **Line 2. A?**

<u>Example 1</u> - Solution

- **Line 2. A?**
- Column A - “Due from” = **0 mil**
- Column B - “Due to” = **4 mil**

<u>Example 2</u> - Problem

- Capital Contribution = **15 mil**
- Net Profit - Branch = **5 mil**
- *Net Loss - IBF* = ***(30 mil)***
- **What is reported in Line 2. A?**

<u>Example 2</u> - Solution

- **Line 2. A?**
- Column A - “Due from” = **(10 mil)**
- Column B - “Due to” = **0 mil**

Example 3 - Problem

Capital Contribution	=	**5 mil**
Net Loss - IBF	=	**(30 mil)**
Net Profit/(Loss) - Branch	=	**0**
Mark-to-market gains from FV hedges	=	***10 mil***

- **What is reported in Line 2. A?**

Example 3 - Solution

- **Line 2. A?**

Column A - "Due from"	=	**(15 mil)**
Column B - "Due to"	=	**0**

<u>Example 4</u> - Problem

- Capital Contribution = **5 mil**
- Net Profit - Branch = **5 mil**
- Net Loss - IBF = **(30 mil)**
- *Net Unrealized <u>Gain</u> on AFS Sec* = ***10 mil***
- What is reported in Line 2. A?

<u>Example 4</u> - Solution

- **Line 2. A?**
- Column A - "Due from" = **(10 mil)**
- Column B - "Due to" = **0 mil**

Key Points

- Net unrealized gains and losses on the available-for-sale securities
- Provision for loan losses
- IBF's net income
- Gains/(losses) from FV and cash flow hedges (Schedule M, Part I, Line 2.a)
- Net income should be reported GROSS of U.S. income taxes on Schedule M

Schedule T

Fiduciary and Related Services

Schedule T
Fiduciary and Related Services

<u>Three sections</u>

- Fiduciary Powers (Items 1 - 3)
- Fiduciary and Related Assets Held (Items 4 - 10)
- Memoranda (Items 1 - 3)
  - Managed Assets Held in Personal Trust and Agency Accounts
  - Corporate Trust and Agency Accounts
  - Collective Investment Funds

Items 1, 2 and 3

- Does the institution have trust powers?
- Does the institution exercise the fiduciary powers it has been granted?
- Does the institution have any fiduciary or related activity to report?

Items 4 -10

- Report market values as of the report date:
  - Managed Assets - Column A
    - Accounts for which institution has investment discretion
  - Non-Managed Assets - Column B
    - Accounts for which the institution does not have investment discretion
  - Number of Managed Accounts - Column C
  - Number of Non-Managed Accounts - Column D

Memoranda Item 1

Managed assets **held in personal trust and agency accounts**

- Breakout of Item 4 above according to asset type
- Used to monitor household investments

Memoranda Item 2

Corporate trust and agency accounts

- Number of issues - Column A
- Principal amount outstanding - Column B
- Corporate and municipal trusteeships
- Transfer agent, registrar, paying agent, and other corporate agency

Memoranda Item 3

<u>Collective investment funds and common trust funds</u>

- Number of funds - Column A
- Market value of fund assets - Column B
- Breakout according to type of asset

Thank You!