



FEDERAL RESERVE BANK
OF DALLAS

April 10, 2001

DALLAS, TEXAS
75265-5906

Notice 01-32

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

**Clarification of Guidance on the
Accounting and Reporting for Loans Held for Sale**

DETAILS

The federal financial institution regulatory agencies have issued guidance to institutions and examiners about the appropriate accounting and reporting treatment for certain loans sold directly from the loan portfolio or transferred to a held-for-sale account. The interagency guidance applies when

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

Selling loans has become an increasingly important portfolio risk management tool for institutions seeking to manage concentrations, change risk profiles, improve returns, and generate liquidity. Examiners, however, have noted differences among institutions in the accounting for and reporting of these transactions. Specifically, accounting inconsistencies relate to how and where initial and subsequent fair value adjustments are recorded, and the reporting of past-due and nonaccrual loans that have been designated as held for sale.

The interagency guidance clarifies existing instructions and promotes accounting transparency consistent with generally accepted accounting principles (GAAP). The guidance reminds institutions to appropriately report reductions in the value of loans transferred to a held-for-sale account through a write-down of the recorded investment to fair value upon transfer. At

the same time, there should be a charge to the institution's allowance for loan and lease losses. Institutions are also reminded that loans transferred to a held-for-sale account should continue to be accorded the same past-due and nonaccrual treatment as other loans.

The Securities and Exchange Commission has reviewed the interagency guidance and determined that the guidance will assist in promoting consistent accounting and reporting treatment for the loan sales and transfers of loans to held-for-sale accounts that are within the scope of the agencies' guidance.

ATTACHMENT

A copy of the agencies' guidance is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis, Banking Supervision Department, (214) 922-6051. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254 or access District Notices on our web site at <http://www.dallasfed.org/banking/notices/index.html>.

Office of the Comptroller of the Currency

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

Office of Thrift Supervision

National Credit Union Administration

Interagency Guidance on Certain Loans Held for Sale

March 26, 2001

PURPOSE, BACKGROUND, AND SCOPE

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration are issuing this Interagency Guidance to provide instruction to institutions and examiners about the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held for sale account.

This guidance applies when:

- an institution decides to sell loans that were not originated or otherwise acquired with the intent to sell,¹ and
- the fair value of those loans has declined for any reason other than a change in the general market level of interest or foreign exchange rates.²

¹ Mortgage loans held for sale that are subject to Financial Accounting Standard (FAS) 65, *Accounting for Certain Mortgage Banking Activities*, should be accounted for at the lower of cost or fair value in accordance with that standard. Other loans that are originated with the intent to sell are required to be reported at the lower of cost or fair value. All loans originated with the intent to sell should be reported in regulatory reports along with other loans held for sale as set forth in Footnote 7. Furthermore, such loans should be reported as past due or nonaccrual, when appropriate.

² This guidance includes a presumption that declines in the fair value of loans are attributable to declines in credit quality. Adjustments to the recorded investment of loans can be excluded from this guidance only when fair value declines result from changes in interest or foreign exchange rates and clearly are not attributable, in any respect, to an increase in credit or transfer risk. The reasons for such exceptions should be adequately supported with objective, verifiable evidence and properly documented.

Thus, this guidance is directed toward loans that have declined in credit quality. This would include, but not be limited to, loans that are past due or in nonaccrual status, have been downgraded or adversely classified (by the institution, examiners, or an external rating agency), have fair value declines reflecting an increase in credit spreads or spreads over the reference rate, or have reduced liquidity related to credit factors.

Selling loans, in whole or in part, has become an increasingly important portfolio risk management tool for institutions seeking to manage concentrations, change risk profiles, improve returns, and generate liquidity. Examiners, however, have noted differences among institutions in the accounting for and reporting of these transactions. Specifically, accounting inconsistencies relate to how and where initial and subsequent fair value adjustments are recorded, and the reporting of past due and nonaccrual loans that have been designated as held for sale. This issuance clarifies existing guidance,³ and promotes accounting transparency consistent with generally accepted accounting principles (GAAP).^{4 5}

TRANSFER TO HELD FOR SALE ACCOUNT

When a decision is made to sell a loan or portion thereof that was not originated or initially acquired with the intent to sell, the loan should be clearly identified and transferred to the held-for-sale (HFS) account. At the time the decision is made, a formal marketing strategy or plan of sale is typically developed. A plan of sale may include, for example, identification of the loans to be sold, the expected method of sale (e.g., securitization or sale in the secondary market), the time period expected for completion of the sale, and an active program to find a buyer.

The transfer to the HFS account should be recorded at the lower of cost or fair value⁶ on the date the decision to sell is made. The best evidence of fair value is a quoted market price. If no quoted market price is available, the following should be considered when estimating a loan's fair value:

³ Instructions for the Federal Financial Institutions Examination Council's (FFIEC) *Consolidated Reports of Condition and Income* (bank Call Report); instructions for the Office of Thrift Supervision's (OTS) *Thrift Financial Report* (TFR); instructions for the National Credit Union Administration's Call Report (NCUA Call Report); FAS 65; FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans or Initial Direct Costs of Leases*; FAS 107, *Disclosures about Fair Value of Financial Instruments*; FAS 114, *Accounting by Creditors for Impairment of a Loan*; FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*; AICPA Practice Bulletin 4, *Accounting for Foreign Debt/Equity Swaps*; Securities and Exchange Commission Staff Accounting Bulletin No. 82 (SAB 82), July 5, 1989, Topic 5.V, Question 2; and the AICPA Audit and Accounting Guide for Banks and Savings Institutions.

⁴ Consistent with GAAP and longstanding supervisory policies, actual credit losses for a loan, which may be for all or part of a particular loan, should be promptly deducted from the ALLL and the recorded investment in the loan should be charged off in the period when deemed uncollectible.

⁵ Documentation requirements covered by the Paperwork Reduction Act have been submitted to, and approved by, the U.S. Office of Management and Budget in connection with the bank Call Report, TFR, and NCUA Call Report information collections.

⁶ Consistent with FAS 114, costs to sell the loan (loan disposition costs) should be reflected in the determination of the loan's fair value.

- Recent cash sales of similar loans;
- Market prices of similar loans including any information received from brokers or dealers;
- Valuations received from independent loan pricing experts;
- The loan's expected cash flows discounted at an appropriate interest rate; and
- The borrower's public debt rating.

An institution's fair value estimates should be clearly supported and documented.

For purposes of the bank Call Report, the TFR, and the NCUA Call Report, institutions must report loans held for sale at the lower of cost or fair value.⁷

FAIR VALUE ADJUSTMENTS

Reporting at Transfer Date

At the time of a loan's transfer to the HFS account, any reduction in the loan's value should be reflected as a write-down of the recorded investment resulting in a new cost basis, with a corresponding reduction in the allowance for loan and lease losses (ALLL). To the extent that the loan's reduction in value has not already been provided for in the ALLL, an additional loan loss provision should be made to maintain the ALLL at an adequate level.

For bank Call Report purposes, the write-down for the loan's reduction in value should be reported as a charge-off in Part I of the schedule on Charge-offs and Recoveries on Loans and Leases and Changes in Allowance for Loan and Lease Losses, and the corresponding reduction in the ALLL should be reported as an "adjustment" to the ALLL in Part II of this schedule.⁸ This adjustment should be described in the Explanations schedule of the bank Call Report as "Write-downs arising from transfers of loans to HFS."⁹ For TFR purposes, the write-down for the loan's reduction in value should be reported as a "charge-off" in the Consolidated Valuation Allowances and Related Data schedule.¹⁰ For NCUA Call Report purposes, the write-down for

⁷ Bank Call Report - Loans held for sale and in the loan portfolio (i.e., loans that a bank has the intent and ability to hold for the foreseeable future or until maturity or payoff) are reported by loan category in Schedule RC-C, Loans and Lease Financing Receivables. Effective March 31, 2001, loans held for sale will be reported as a separate asset category on the balance sheet (Schedule RC). TFR - The TFR instructions require that loans held for sale be reported along with the loan portfolio (i.e., loans held for investment) by loan category on the balance sheet on Schedule SC - Consolidated Statement of Condition. In addition, TFR instructions require that loans held for sale be reported along with certain other assets held for sale on Schedule SI - Consolidated Supplemental Information. NCUA Call Report - Loans held for sale are reported along with the loan portfolio by category on the Statement of Financial Condition and on applicable supplementary schedules Schedule A - Real Estate Loans/Lines of Credit (Outstanding Balances) and Schedule B - Member Business Loans. NCUA plans to institute a separate loans held for sale asset category on the Statement of Financial Condition effective March 31, 2002.

⁸ Schedule RI-B, Part I - Charge-offs and Recoveries on Loans and Leases, and Part II - Changes in Allowance for Loan and Lease Losses.

⁹ Schedule RI-E, Explanations, item 6, "Adjustments to the allowance for loan and lease losses." A preprinted caption for the description of this "adjustment" will be provided in Schedule RI-E, item 6.a, effective for the June 30, 2001, report date.

¹⁰ Schedule VA - Reconciliation, and Charge-offs, Recoveries, and Specific Valuation Allowance Activity.

the loan's reduction in value should be reported as a "charge-off" in the Loan Information schedule and in applicable supplementary loan schedules.¹¹

For financial reporting purposes, reductions in the ALLL for loans transferred to the HFS account, if material, should be separately disclosed and appropriately described in the presentation of the activity in the ALLL during the period.

Subsequent Declines in Value

After a loan or group of loans is transferred to the HFS account, these assets must be revalued at each subsequent reporting date until sold and reported at the lower of cost or fair value. Any declines in value (including those attributable to changes in credit quality) and recoveries of such declines in value occurring after the transfer to the HFS account should be accounted for as increases and decreases in a valuation allowance for HFS loans, not as adjustments to the ALLL. Changes in this valuation allowance should be reported in current earnings.¹² The valuation allowance for HFS loans cannot be reduced below zero (i.e., cannot have a debit balance). Such valuation allowances should not be reported as part of the ALLL and are not eligible for inclusion in Tier 2 capital for risk-based capital purposes.

Furthermore, for financial reporting purposes, when these income or expense amounts relating to increases or decreases in the valuation allowance are material, they should be separately disclosed and appropriately described either on the face of the income statement or in the notes to the financial statements.

PAST DUE AND NONACCRUAL ISSUES

Loans transferred to the HFS account should continue to be accorded the same past due and nonaccrual treatment as other loans, and should be reported as past due or nonaccrual when appropriate.¹³ For regulatory reporting purposes, when an institution holds portions of a nonaccrual loan in both the loan portfolio and the HFS account, the institution should report both portions of the loan as nonaccrual until the loan meets the requirements for restoration to accrual status. All portions of the nonaccrual loan are required to be reported in the same manner because the entire amount is dependent on the same source of repayment.

¹¹ Loan Information, Schedule A – Real Estate Loans/Lines of Credit (Outstanding Balances), and Schedule B – Member Business Loans.

¹² Bank Call Report - See the instructions for Schedule RI - Income Statement, Item 5.i, effective March 31, 2001. TFR - See the instructions for Schedule SO - Consolidated Statement of Operations - under Noninterest Income, Line SO465, LOCOM Adjustments made to Assets Held for Sale. NCUA Call Report - Income and Expense.

¹³ Bank Call Report - See the Glossary entry for "nonaccrual status" and the instructions for Schedule RC-N - Past Due and Nonaccrual Loans, Leases and Other Assets. TFR - See the instructions for Schedule PD - Consolidated Past Due and Nonaccrual. NCUA Call Report - See the instructions for Loan Information, Schedule A – Real Estate Loans/Lines of Credit (Outstanding Balances), and Schedule B – Member Business Loans.

CONTACTS

If you have any questions about this issuance, please contact Louise A. Francis at the Office of the Comptroller of the Currency (202-874-1306), Gregory Eller at the Board of Governors of the Federal Reserve System (202-452-5277), Doris L. Marsh at the Federal Deposit Insurance Corporation (202-898-8905), Harrison E. Greene, Jr., at the Office of Thrift Supervision (202-906-7933), or Karen Kelbly at the National Credit Union Administration (703-518-6389).

APPENDIX

Example 1

The following is an example of the accounting for a loan that was transferred to the HFS category.

PRIOR TO DECISION TO SELL:

A single payment commercial loan was originated with a principal balance of \$100, which was also the loan's recorded investment at origination. The loan was individually evaluated for impairment under FAS 114. Deterioration in the borrower's repayment capacity was noted, and the loan was determined to be impaired. An allowance of \$20 was established for this loan in accordance with FAS 114 and included in the ALLL, with a corresponding charge to earnings. Subsequently, the institution determined that a partial charge-off of \$8 was needed. The loan was written down by this amount, with a corresponding reduction in the ALLL.

The journal entries to record the impairment and partial charge-off are as follows:

Dr. Provision for loan and lease losses	\$20	
Cr. Allowance for loan and lease losses (ALLL)		\$20
Dr. Allowance for loan and lease losses	\$8	
Cr. Loans		\$8

The components of the carrying amount of the loan are as follows:

Recorded investment (historical cost)	\$100
Partial charge-off/write-down	<u>(8)</u>
Recorded investment (cost basis, as adjusted)	\$92
Remaining allowance for loan and lease losses (after charge-off)	<u>(12)</u>
Carrying amount, prior to transfer to HFS	<u>\$80</u>

REPORTING AT TRANSFER DATE:

The institution decided to sell the loan and established a plan of sale. The fair value (based on recent cash sales of similar loans) was estimated to be \$75. At the time of the transfer to the HFS account, the ALLL was increased by \$5 to recognize the further decline in the value of the loan from \$80 to \$75. The recorded investment in the loan was written down to the fair value of the loan, with a corresponding reduction in the remaining allowance of \$17 [\$12 + \$5].

The journal entries to record the additional decline in value of the loan and the transfer to the HFS account are as follows:

Dr. Provision for loan and lease losses	\$5	
Cr. Allowance for loan and lease losses		\$5
Dr. Allowance for loan and lease losses	\$17	
Cr. Loans		\$17
Dr. Loans held for sale	\$75	
Cr. Loans		\$75

The components of the carrying amount are as follows:

Recorded investment (cost basis, as adjusted) prior to transfer to HFS	\$92
Write-down recognized at time of transfer	<u>(17)</u>
Recorded investment (new cost basis) and carrying amount upon transfer to HFS	<u>\$75</u>

SUBSEQUENT DECLINE IN VALUE:

In a subsequent reporting period, the fair value of the loan further declined from \$75 to \$68.

The journal entry to record this decline in value is as follows:

Dr. Noninterest income/expense ¹⁴	\$7	
Cr. HFS valuation allowance		\$7

The components of the carrying amount are as follows:

Recorded investment (new cost basis) upon transfer to HFS	\$75
HFS valuation allowance	<u>(7)</u>
Carrying amount	<u>\$68</u>

¹⁴ For financial reporting purposes, if this amount is material, it should be separately disclosed and appropriately described in the income statement.

Example 2

The following is an example of the accounting for a loan when a decision is made to sell the loan and the loan is sold immediately.

PRIOR TO DECISION TO SELL:

A single payment commercial loan was originated with a principal balance of \$100, which was also the loan's recorded investment at origination. The loan was individually evaluated for impairment under FAS 114. Deterioration in the borrower's repayment capacity was noted, and the loan was determined to be impaired. An allowance of \$7 was established for this loan in accordance with FAS 114 and included in the ALLL, with a corresponding charge to earnings. Subsequently, the institution determined that a partial charge-off of \$7 was needed. The loan was written down by this amount, with a corresponding reduction in the ALLL.

The journal entries to record the impairment and partial charge-off are as follows:

Dr. Provision for loan and lease losses	\$7	
Cr. Allowance for loan and lease losses (ALLL)		\$7
Dr. Allowance for loan and lease losses	\$7	
Cr. Loans		\$7

The components of the carrying amount of the loan are as follows:

Recorded investment (historical cost)	\$100
Partial charge-off/write-down	<u>(7)</u>
Recorded investment (cost basis, as adjusted) and carrying amount	<u>\$93</u>

VALUATION AT THE TIME OF SALE:

The institution decided to sell the loan and immediately found a purchaser to whom the loan was sold for \$90. At the time of the sale, the ALLL was increased by \$3 to recognize the further decline in value of the loan from \$93 to \$90. The recorded investment in the loan was written down to the sales price of the loan (its fair value), with a corresponding reduction in the ALLL of \$3.

The journal entries to record the additional decline in value of the loan and the transfer to HFS are as follows:

Dr. Provision for loan losses	\$3	
Cr. Allowance for loan and lease losses		\$3
Dr. Allowance for loan and lease losses	\$3	
Cr. Loans		\$3

Dr. Loans held for sale	\$90	
Cr. Loans		\$90

The components of the carrying amount of the loan immediately prior to recording the sale are as follows:

Recorded investment (cost basis, as adjusted)	\$93
Additional write-down recognized at time of sale	<u>(3)</u>
Recorded investment (new cost basis) and carrying amount at time of sale	<u>\$90</u>

The journal entry to record the sale of the loan is as follows:

Dr. Cash	\$90	
Cr. Loans held for sale		\$90