FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10271**
November 23, 1988]

INTEREST RATE SWAP REPORTING STANDARDS

Comment on FFIEC Proposal Invited by January 9, 1989

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

The Federal Financial Institutions Examination Council (FFIEC) has requested public comment on a proposal to include in the instructions to the Reports of Condition and Income (Call Reports) submitted by banking institutions to their regulatory agencies a requirement to report income from interest rate swaps over the life of the swap contract. The proposed Call Report requirement would become effective for all interest rate swap contracts entered into after December 31, 1988.

The following statement was issued by the FFIEC:

> The Examination Council has announced its approval of the issuance for public comment of a Call Report instruction relating to the reporting of income from interest rate swaps.
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> The proposed instruction would require that income from interest rate swaps be recognized over the life of the swap contract, rather than at the swap's inception. Also, changes in the market value of swaps subsequent to their inception (except for most swaps accounted for as hedges) would have to be reflected in the bank's income in the period in which the changes occur.
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> Interest rate swaps, in their simplest form, are contractual agreements between two parties to exchange interest payments periodically over the life of the swaps. One party typically agrees to make fixed-rate interest payments while the other party agrees to make variable-rate payments on an amount specified in the contract. Swaps are used by banks to help meet their customers' needs relating to asset-liability management or by the banks themselves for their own requirements.
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> In approving the proposed instruction, the Council determined that the recognition of income at the date of the swap's inception is not appropriate from a regulatory standpoint because such a practice overstates income and capital. Substantial risk continues to be incurred by a bank over the life of a swap, and income may never be realized if unfavorable events occur.
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> The proposed instruction would be a Glossary entry that would be included in the Instructions for the Preparation of Reports of Condition and Income (Call Reports) for FDIC-insured commercial and State-chartered savings banks. It is being issued for public comment for 60 days and would become effective for all interest rate swaps entered into after December 31, 1988.

Printed on the following pages is the text of the FFIEC's proposal, which has been reprinted from the *Federal Register* of November 9, 1988. Comments should be submitted by January 9, 1989, and may be sent directly to Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council, 1776 G Street, NW., Suite 701, Washington, D.C. 20006. Questions regarding the proposal may be directed to our Supervision Support Department (Tel. No. 212-720-6357).

E. GERALD CORRIGAN,
President.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Interest Rate Swap Reporting Standards

AGENCY: Federal Financial Institutions Examination Council

ACTION: Request for comment.

SUMMARY: This proposal, which pertains to interest rate swap contracts ("swaps"), would preclude al FDIC-insured U.S. commercial banks and FDIC-insured state-chartered savings banks, for purposes of the Reports of Condition and Income (Call Reports), from recognizing arrangement fees and spread income at the inception of a swap. Instead, this income would be recognized over the life of the swap. It also would require that subsequent changes in the market value of swaps, except for most swaps accounted for as hedges, be reflected in income during the period in which the changes occur. This proposed Call Report instruction has been developed jointly by the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board ("FRB"), and the Federal Deposit Insurance Corporation ("FDIC"), under the auspices of the Council. The instruction will be effective for swap contracts entered into after December 31, 1988, and the first Call Report affected will be the Call Report for March 31, 1989.

DATE: Comments must be received on or before January 9, 1989.

ADDRESS: All comments should be mailed to Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council, 1776 G St., NW., Suite 701, Washington, DC 20006, or delivered to the same address between the hours of 9:00 a.m. and 5:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: David C. Motter, Special Assistant to the Chief National Bank Examiner, (202/447–1587), Office of the Comptroller of the Currency, 490 L'Enfant Plaza East SW., Washington, DC 20219.

Board: Rhoger H. Pugh, Manager, Division of Banking Supervision and Regulation, (202/728–5883), Board of Governors of the Federal Reserve System, 20th & Constitution Avenue NW., Washington, DC 20551.

FDIC: Robert F. Storch, Chief, Securities and Accounting Section, Division of Bank Supervision, (202/898–8906), Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

SUPPLEMENTARY INFORMATION: This proposed Call Report instruction was developed on a joint interagency basis by the OCC, FRB, and the FDIC due to concerns over the lack of a consistent authoritative standard regarding the recognition of swap income. The agencies are not relying upon generally accepted accounting principles as the reporting standard for these transactions because there is an overall lack of authoritative accounting guidance pertaining to swap income and such guidance is not likely to be forthcoming from accounting rulemaking authorities for some time. When and if accounting rulemaking authorities adopt authoritative guidance for the recognition of swap income, the banking agencies will reconsider the appropriateness of any reporting standard for swaps that becomes inconsistent with generally accepted accounting principles.

Proscription on the Immediate Recognition of Fees and Spreads

In the absence of specific authoritative accounting pronouncements in this area, banks have generally followed two basic approaches in accounting for swap income. One method recognizes the arrangement fee and the discounted present value of the spread on a portfolio of swaps, net of a provision for related credit risk and administrative costs, as profit at the inception of the swap. The second method amortizes the arrangement fees and takes the spread into income over the life of the swap, i.e., income is recognized as the swap payments are accrued each period.

The Council believes the second method of income recognition is the more appropriate method for Call Report purposes. Swap income should not be recognized at inception, since that practice is not in accordance with the fundamental accounting principle that income earned as a result of a contractual obligation should be recognized over the life of the contract. The logic that the income is earned over that time period rather than at the inception of the swap is supported by the fact that, in the case of a bank acting as a principal in a swap contract, credit risk, interest rate risk, and administrative costs are incurred over the life of the contract. Therefore, since costs and risks are incurred by the bank over the swap's life, it is appropriate that the income from the swap be recognized over the life of the swap.

The immediate recognition of income leads to higher reported income and capital at the time a swap is booked. However, substantial risks remain over the life of the contract and the recorded income may not be ultimately realized due to credit losses or adverse interest rate changes. Consequently, the Council believes that income recognition at the swap's inception is an unsafe or unsound banking practice.

Recording Changes In Market Value After Inception

The second aspect of the proposed Call Report instruction deals with whether changes in the market values of swaps after their inception should be recorded in income in the period in which they occur. The value of an imperfectly matched swap portfolio can change markedly with changes in interest rates, and the value of an individual swap contract is also subject to change if the creditworthiness of the counterparty changes. Therefore, it is important to set a reporting standard that currently records such changes in value. The proposed Call Report instruction would require that changes in the market value of swaps (except most swaps accounted for as hedges) be recorded in the period in which they occur, with the cumulative change in market value being reported in the Report of Condition. Therefore, any losses in value in a bank's swap portfolio would be reflected in current period income rather than being deferred, thus providing more discipline to banks engaging in the swap market.

Issues for Specific Public Comment

The Council is aware of the current diversity in practice in accounting for swaps. The proposed Call Report instruction would promulgate the accounting considered appropriate for supervisory purposes commensurate with the federal banking agencies' safety and soundness responsibilities. The Council intends to seek general public comment concerning the proposed Call Report instruction and encourages specific comments on the following additional issues:

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1. The proposal would require that arrangement fees and spread income be recognized as income over the life of the swap contract. The Council requests comment on whether certain costs directly related to originating a swap contract should be deferred and amortized over the life of the swap, similar to the method prescribed for loan origination costs under FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases". The Council also seeks comment on an alternative to deferring the costs. This alternative is to allow the arrangement fee (but not the spread) to be recorded as income at inception, to the extent it does not exceed the direct costs of originating the related swap contract.

2. The proposed Call Report instruction would require that changes in the market value of swaps subsequent to inception (except most swaps accounted for as hedges) be recognized in income during the period they occur. Market valuation methods that have been used by banks include the following:

a. The present value of the known cash flows from the swap is calculated using as a discount rate the current rate on a Treasury security of equal remaining maturity plus the excess at inception of the swap rate (defined as the mid-point of the fixed rate side's bid and ask rate) over the rate on a Treasury security of equal maturity.

b. The present value of the known cash flows from the swap is calculated using as a discount rate the current swap rate (defined as the mid-point of the fixed rate side's bid and ask rate) on a swap with equal remaining maturity.

c. The present value of the known cash flows from the swap is calculated using as discount rates the zero coupon rates derived from the current swap yield curve. Swap yields for each maturity are defined as the midpoint of the fixed rate side's bid and ask rates.

The Council requests comment on which of these valuation methods is most appropriate. The Council also requests details on alternatives to the above methodologies that may be more appropriate in all or certain circumstances.

Proposed Instruction

The text of the proposed instruction follows:

Proposed Call Report Glossary Entry for Interest Rate Swaps

An interest rate swap, in its simplest form, entails an agreement between two parties ("counterparties") to exchange interest payments for a specified period of time. These interest payments are calculated on a specified principal value, called the notional amount. Ordinarily, counterparties are only obligated to pay to each other the interest due on this amount and are not obligated to repay the underlying or related principal.

Interest rate swaps are often used to, in effect, transform the interest rates associated with assets or liabilities from fixed-rate to floating-rate or vice versa, or from one floating rate index to another. Banks generally engage in interest rate swaps either to hedge their exposures to interest rate risk or to generate fee income by acting as intermediaries between other swap participants or by trading in swaps.

Since notional principal amounts are not counterparty obligations for single-currency interest rate swaps, these amounts should not be reported on Schedule RC, Balance Sheet. These amounts should be reported on Schedule RC–L, "Commitments and Contingencies," in Memoranda Item 3, "Notional Value of All Outstanding Interest Rate Swaps," as discussed in the instructions for that schedule.

Some cross-currency interest rate swaps—those involving obligations of the respective parties denominated in different currencies—also obligate the counterparties to exchange principal amounts at maturity. Such principal amounts shall be reported on the FFIEC 031, 032, and 033 as "Commitments to Purchase Foreign Currencies and U.S. Dollar Exchange," in Item 5 of Schedule RC–L (not reported on the FFIEC 034). Such transactions can alter a bank's foreign exchange risk position.

Bank management should evaluate the credit risk associated with interest rate swap activities. An allowance for credit losses should be maintained that is sufficient to cover any estimated credit losses associated with swap activities.

Under interest rate swaps, the amounts of interest receivable and payable should be accrued as of the end of each calendar quarter (or more frequently). The receivable and payable balances relating to a particular swap may be reported net only if a contractual right of offset exists and the swap payments are exchanged on a net basis. The aggreate amounts of receivables and payables should be reported as "Other Assets" and "Other Liabilities," respectively, on Schedule RC-Balance Sheet (Items 11 and 20, respectively) and on Schedule RC–F ("Other Assets," Item 3) and Schedule RC–G ("Other Liabilities," Item 4). For purposes of these reports, receivables and payables shall not be accrued for amounts applicable to periods beyond the report date.

In no case shall income be recognized at the inception of a swap. Arrangement fees must be recognized as income over the life of the swap contract. Spread income, i.e., the difference between future cash receipts and payments for a portfolio of swaps, must be recognized only as accrued for the current period, i.e., not beyond the report date.

A bank's activities using interest rate swaps, both as hedges and non-hedges, are subject to review by examiners. Accordingly, banks must fully document their swap hedging policies and transactions. A pattern of excessive and unsatisfactorily documented hedge swap terminations may lead examiners to conclude that an institution has in effect been trading in swaps and require that the results of such swap activities be restated and reported as swaps not used for hedging purposes.

FASB Statement No. 80, *Accounting for Futures Contracts*, for swaps denominated in one currency, and Statement No. 52, *Foreign Currency Translation*, for swaps denominated in more than one currency, should be consulted for additional information regarding accounting standards to be applied by analogy to interest rate swaps.

Reporting for Hedge Swaps

Swaps that are used to reduce a bank's interest rate risk exposure may be reported as hedges of such risk if, in principle, all of the hedging criteria set forth in FASB Statement No. 80 have been fulfilled. Therefore, for example, the specific item to be hedged must expose the enterprise to price (or interest rate) risk, and the swap must reduce that exposure and be designated as a hedge of that item. Swaps denominated in more than one currency that are used to reduce a bank's interest rate or foreign exchange risk may be reported as hedges of such risks if, in principle, all of the hedging criteria set forth in FASB Statement No. 52 have been met. However, in no case may swaps used to hedge other swaps be reported as hedges. For example, offsetting swaps for which a bank is acting as an intermediary are not swaps that reduce its interest rate risk exposure.

If the hedge criteria are met, the accounting for the swap shall be related to the accounting for the hedged item so that changes in the market value of the swap are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized. Therefore, the income or expense from the swap should be reported in Schedule RI, Income Statement, in the same line item as the income or expense from the underlying hedged item. In most cases, the swap's accrued interest income or expense for the period shall adjust the underlying interest income or expense of the hedged item. In addition, the change in the market value of the swap shall be deferred and accounted for as part of the carrying value of the item being hedged, and reflected as an adjustment of the related interest income or expense over the life of the hedged item. However, if the swap hedges an underlying item which is carried at market value (mark to market accounting), a change in the market value of the related swap shall not be deferred but rather should be recognized in income in the period the change in value occurs.

If a swap is accounted for as a hedge (of an underlying item not carried at market value), then the gain or loss on an early termination of the swap shall be defferred, recognized as part of the carrying value of the hedged item, and amortized over the remaining life of the hedged item or the swap, whichever is shorter. Generally, terminations of swaps that are used for hedging purposes should not be significant in relation to the total number or notional amount of swaps that are hedges.

Reporting for Non-Hedge Swaps

For all interest rate swaps that are not reportable as hedges as set forth in the preceding section, the income or expense associated with the accrual of swap receivables and payables shall be reported as "Other Noninterest Income," in Schedule RI (Income Statement), Item 5.f. (item 5.b. on the FFIEC 034), or as "Other Noninterest Expense," in Schedule RI, Item 7.c., as appropriate.

At the first Call Report date following the inception of an interest rate swap, any change in the market value of that swap since its inception shall be recognized in current period income or expense. At each successive Call Report date, any change in the market value of that swap since the previous Call Report date must be recognized in current period income or expense, using a consistent methodology.

These changes in the market value of swaps shall be reflected in Scheduled RI, Item 5.f. (item 5.b. on the FFIEC 034), "Other Noninterest Income," or Item 7.c., "Other Noninterest Expense," as appropriate. The cumulative valuation exposure (asset or liability) on the balance sheet shall be reported as "Other assets," in Schedule RC, Item 11, or as "Other liabilities," in Schedule RC, Item 20.

If a non-hedge swap is terminated early, any amounts the reporting bank receives from or pays to the counterparty on early termination shall be reported net as "Other Noninterest Income," in Schedule RI, Item 5.f. (item 5.b. on the FFIEC 034), or as "Other Noninterest Expense," in Schedule RI, Item 7.c., as appropriate.

November 4, 1988.

Robert J. Lawrence,

Executive Secretary, Federal Financial Institutions Examination Council.

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