

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

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CHESTER B. FELDBERG
EXECUTIVE VICE PRESIDENT

November 18, 1992

TO THE CHIEF EXECUTIVE OFFICERS OF ALL STATE MEMBER
BANKS IN THE SECOND FEDERAL RESERVE DISTRICT

SUBJECT: FEDERAL RESERVE CONFIRMATIONS OF CHARGE-OFFS DECLARED
FOR TAX PURPOSES

Under longstanding regulations of the Internal Revenue Service (IRS) (i.e., section 1.166-2(d)(1) of the Income Tax Regulations), a commercial bank can support its loan charge-offs by obtaining written confirmation from its primary federal regulator that such charge-offs would have been required for regulatory purposes. In particular, such confirmations indicate that loans charged off by the bank between examinations would have been ordered by an examiner had the bank been under examination at the time of the charge-off. Since September 1973, the Federal Reserve has assisted state member banks by issuing, upon request and in appropriate circumstances, "confirmation letters" that are acceptable to the IRS.

Recently, the IRS added section 1.166-2(d)(3) to the Income Tax Regulations in order to provide commercial banks with an alternative approach to support bad debt deductions.¹ Under this approach, a bank, as an alternative to obtaining written confirmation of its charge-offs, can obtain from its primary federal regulator an "express determination letter" certifying that the bank's loss classification standards for loan charge-offs are consistent with regulatory requirements.

After due consideration, and in cooperation with the U.S. Department of the Treasury and the other federal bank and thrift supervisory agencies, the Federal Reserve has determined that it will provide a state member bank, upon its request and in appropriate circumstances, either of the above letters. The

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¹ The new IRS regulation was published in the Federal Register on February 24, 1992, and an amendment to the regulation was published on October 2, 1992.

Federal Reserve's guidance to examiners on these letters is attached and sets forth the procedures and circumstances in which the Federal Reserve will issue them.

Any questions on this guidance should be directed to Barbara A. Klein, Manager, Domestic Banking Department, at (212) 720-8324.

Yours sincerely,



Attachment

**EXAMINER GUIDANCE ON REVIEWING
LOAN LOSSES FOR TAX PURPOSES**

A commercial bank can obtain conclusive support for the loan charge-offs it declares for federal income tax purposes by obtaining, from its primary federal regulator, either (1) a "confirmation letter" indicating that the bank's charge-offs would have been required for regulatory purposes, or (2) an "express determination letter" certifying that the bank's loan loss classification standards are consistent with regulatory requirements. These letters are authorized by the Internal Revenue Service (IRS) in section 1.166-2(d) of the Income Tax Regulations. The Federal Reserve has determined that it will provide a state member bank, upon its request and in appropriate circumstances, either of the above letters. Examiner guidance on issuing these letters is set forth below.

Express Determination Letters

Under the IRS regulations relating to express determination letters, a commercial bank may elect to conform its tax treatment of bad debts with its regulatory reporting. Institutions making this election and meeting the IRS's requirements will automatically be allowed to declare charge-offs for federal income tax purposes in the same year it takes charge-offs for regulatory purposes.

To be eligible, a bank must file a conformity election with its federal tax return. The regulations also require the bank's primary federal supervisory agency to determine expressly that the bank maintains and applies classification standards for loan charge-offs that are consistent with regulatory requirements. To continue using the new method, the bank must request a new letter at each subsequent examination that covers the loan review process. According to the IRS regulations, express determination letters may be issued to support charge-offs of commercial banks, but not bank holding companies and non-bank subsidiaries of the bank or holding company.

Procedures

The bank is responsible for requesting an express determination letter. The request should be made immediately prior to or at the start of an examination to the examiner-in-charge.

The examiner-in-charge will issue the letter only at the completion of an examination that covers the bank's loan review process and only when the examiner concludes that its issuance is appropriate. The letter will be signed and dated by the examiner-in-charge and provided to the bank for its files.

The letter is not part of the examination report, but a copy of it should be maintained in the examination work papers and supported by adequate documentation. Federal Reserve standards for loan charge-offs and classification standards are set forth in Section 211 (Installment Loans), Section 214 (Credit Card Plans), and in Section 217 (Classification of Credits) of the Commercial Bank Examination Manual, as well as in supplementary policy guidance. The letter will be issued only if:

- o The examination indicates that the bank maintains and applies loan loss classification standards that are consistent with Federal Reserve standards regarding the identification of losses and charge-off of loans.
- o There are no material deviations from regulatory standards. Minor criticism of the bank's loan review process or immaterial deviations from regulatory standards should not preclude issuance of the letter; however, any criticisms or deviations should be discussed by the examiner with senior staff of the Reserve Bank before an express determination letter is provided.

The letter should not be issued if any of the following occur:

- o The bank's loan review process relating to charge-offs is subject to significant criticism.
- o Loan charge-offs for call report purposes are materially misstated.
- o There are instances of material loan charge-offs not being recognized in the appropriate year.
- o Many loan charge-offs are not recognized in the appropriate year.

Revoking the Election

The bank's election of the new method is to be revoked automatically if the examiner does not issue an express determination letter at the end of an examination covering the loan review process. The Federal Reserve is not required to rescind any previously issued determination letters.

Failure by the bank to obtain a determination letter generally revokes the bank's election for the current year. However, it generally does not invalidate a bank's election for prior year(s). Failure to obtain a determination letter places the burden of proof on the bank to support its loan charge-offs for tax purposes. In certain instances, the bank may qualify for a letter confirming the appropriateness of its charge-offs (as discussed in the next major section below).

Language for Express Determination Letters

TO WHOM IT MAY CONCERN:

In connection with the most recent examination of [NAME OF BANK], by the Federal Reserve Bank of [DISTRICT] as of [EXAMINATION DATE], we reviewed the institution's loan review process as it relates to loan charge-offs. Based on our review, we concluded that the bank, as of that date, maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.

This statement is made on the basis of a review that was conducted in accordance with our normal examination procedures and criteria, including sampling of loans in accordance with those procedures and criteria. It does not in any way limit or preclude any formal or informal supervisory action (including enforcement actions) by this supervisory authority relating to the institution's loan review process or the level at which it maintains its allowance for loan and lease losses.

Examiner-in-charge

Confirmation Letters

The longstanding Federal Reserve policies and procedures for confirming charge-offs are set forth in the attached letter dated September 7, 1973 sent to the officer in charge of examinations at each Federal Reserve Bank (excluding attachments which reiterated the guidance included in the letter). These policies and procedures remain in effect. Confirmation letters generally will be provided only for a bank and its subsidiaries.

To assist the examiner in issuing confirmation letters, it will be necessary for the bank to provide the examiner a list of charge-offs, including the name of the borrower, the amount charged off, the date charged off, the unpaid balance, and the length of time each loan was delinquent when charged off. Furthermore, the bank should maintain complete records supporting the charge-offs, including financial statements, other supporting documents, and the reasons for making the charge-offs. Examiners should furnish the confirmation letter to the bank along with the bank's list of charge-offs (adjusted as necessary based on the examiner's review) based on a review of charged-off loans that are significant in amount in relation to the size of the bank and, for other loans, a review of the charge-off policies of the bank for such loans and a review of an adequate sample of the loan charge-offs.

Language for Confirmation Letters

TO WHOM IT MAY CONCERN:

In connection with the safety and soundness examination of [NAME OF BANK] by the Federal Reserve System as of [EXAMINATION DATE], we reviewed the institution's loan charge-offs. Based on our review, had the institution been examined as of the dates of the charge-offs on the attached list, the loans would have been required to be charged-off on those dates.

This statement is made on the basis of a review of the institution's loan charge-offs, including sampling of loan charge-offs in accordance with our policies and procedures. This statement does not attest to the adequacy or sufficiency of the institution's charge-offs. Furthermore, it does not in any way limit or preclude any formal or informal supervisory actions (including enforcement actions) by this supervisory agency relating to the institution's loan review process or the level at which it maintains its allowance for loan and lease losses.

Examiner-in-charge

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



DIVISION OF SUPERVISION
AND REGULATION

September 7, 1973

TO THE OFFICER IN CHARGE OF EXAMINATIONS
AT EACH FEDERAL RESERVE BANK

On January 24, 1973, the Internal Revenue Service amended Section 1.166-2(d) of its Income Tax Regulations to require banks to obtain a written confirmation from the supervisory authorities that loans voluntarily charged off would have been classified as "loss" had an examination been made on the dates of the charge-offs.

Please instruct your examiners, when requested by State member banks, to review individually during the examination any such charge-offs voluntarily made by the bank prior to the examination to determine if such loans would have been classified "loss" if an examination had been conducted at the time of the charge-offs. All such loans determined to have been a "loss" at the time of the charge-offs should be listed in writing and a confirmation of their worthlessness given to the bank. The confirmation given should include the name of the borrower, the date charged off, the unpaid balance, and the length of time each loan was delinquent when charged off.

All charged-off loans significant in amount in relation to the size of the bank should be reviewed individually to determine their value or lack of value at the time of the charge-off. However, in those instances where banks have charged off small loans or blocks of installment loans, it is not necessary to review each such loan. The examiner should nevertheless satisfy himself that charge-off policies on such loans are reasonable and that a review of an adequate sample of the charge-offs substantiates that such policies are being followed.

There is attached a copy of a letter which should be sent to each State member bank to assure that adequate records will be available on which the examiner can base a determination.

Attached also is a copy of a letter from the Internal Revenue Service containing approval of the procedures outlined above.


John T. McClintock
Assistant Director

(without attachments)