

AT-10800

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

AREA CODE 212-720-5000

August 23, 1995

To: The Chief Executive Officer of Each State Member Bank and Bank Holding Company

Subject: Supervisory Guidance related to FASB Statement No. 114

The Federal Financial Institutions Examination Council ("FFIEC") recently adopted Financial Accounting Standards Boards Statement No. 114, "Accounting by Creditors for Impairment of a Loan" ("FAS 114"), as amended by Statement No. 118, "Accounting by Creditors for Impairment of a Loan -- Income Recognition and Disclosures" ("FAS 118"), for purposes of bank reporting in Call Reports. The FFIEC also determined that although banks must use FAS 114 to determine the portion of the ALLL attributable to impaired loans, separate reporting of this portion would not be required for Call Reports. The overall ALLL should continue to be reported on existing Call Report line items.

The attached letter, SR 95-38, discusses how banks should determine and report the ALLL in accordance with FAS 114. Additionally, SR 95-38 reviews supervisory issues related to the implementation of FAS 114 and FAS 118, including the loan identification and classification process; the treatment of collateral dependent loans, charge-offs, and additional allowances; income recognition on impaired loans; and regulatory reporting, disclosure and capital.

Should you have any questions regarding these issues please contact Sarah Dahlgren, Manager, at (212) 720-7537 or Michael Tursi, Senior Financial Specialist, at (212) 720-2824.

Sincerely,

*Christine M. Cumming*  
Christine M. Cumming  
Senior Vice President



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING  
SUPERVISION AND REGULATION

SR 95-38 (SUP)

June 26, 1995

**TO THE OFFICER IN CHARGE OF SUPERVISION  
AT EACH FEDERAL RESERVE BANK**

**SUBJECT:** Supervisory Guidance related to FASB Statement No. 114

Financial Accounting Standards Board Statement No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114), as amended by Statement No. 118, "Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures" (FAS 118), sets forth standards for estimating the impairment of a loan for general financial reporting purposes. This letter provides guidance for use by examiners in assessing the portion of the allowance for loan and lease losses (ALLL) established for impaired loans under FAS 114 in conjunction with the evaluation of the overall adequacy of a bank's loan loss allowance. Guidance is also provided herein on other supervisory issues affected by FAS 114.<sup>1</sup> In summary, while allowances established under FAS 114 should be considered by examiners in performing an evaluation of the adequacy of a bank's allowance, examiners should continue to focus primarily on the assessment of the adequacy of the overall ALLL:

Summary of FAS 114

FAS 114, as amended by FAS 118 with regard to income recognition, establishes generally accepted accounting principles (GAAP) for use by banking organizations and other creditors when accounting for the impairment of certain loans. According to FAS 114, a loan is "impaired" when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal

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<sup>1</sup> This guidance applies to examinations of state member banks which file Reports of Condition and Income (Call Reports) with the Federal Reserve. Except for the guidance on the regulatory capital treatment of the portion of the ALLL established under FAS 114, this guidance does not directly apply to bank holding companies; however, bank holding companies are required to follow FAS 114 in FR Y-9C Reports. The guidance included herein is generally not applicable to U.S. branches and agencies of foreign banks for purposes of preparing FFIEC 002 reports. U. S. branches and agencies of foreign banks should refer to SR 95-4 for further guidance on the ALLL.

and interest) according to the contractual terms of the loan agreement.<sup>2</sup>

When a creditor has determined that a loan is impaired, FAS 114 requires that an allowance be established based on the present value of expected future cash flows of the loan discounted at the loan's effective interest rate (i.e., contract rate, as adjusted for any net deferred loan fees or costs, premium, or discount) or, as a practical expedient, at the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Since allowances under FAS 114 apply only to a subset of loans (i.e., those that are subject to the standard and that are deemed to be impaired), FAS 114 does not address the adequacy of a creditor's overall ALLL or how the creditor should assess the adequacy of its ALLL.

FAS 114 is effective for fiscal years beginning after December 15, 1994, and earlier application was permitted. FAS 118 is effective concurrently with FAS 114.

#### Supervisory Guidance

FAS 114, as amended by FAS 118, has been adopted by the Federal Financial Institutions Examination Council (FFIEC) for purposes of reporting by banks in Call Reports, subject to the additional regulatory reporting guidelines discussed below.<sup>3</sup> Furthermore, the FFIEC concluded that FAS 114 sets forth methods for establishing only a portion of an institution's ALLL. Accordingly, while the methods set forth in FAS 114 must be used by banks in determining the portion of the ALLL attributable to impaired loans as defined by FAS 114 for purposes of reporting in Call Reports, no separate reporting of the portion established under FAS 114 has been required in such reports. The overall ALLL should continue to be reported on existing Call Report line items.

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<sup>2</sup> FAS 114's guidance on impairment does not apply to "large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment," loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FAS 115, "Accounting for Certain Investments in Debt and Equity Securities." FAS 114 also generally applies to loans that are restructured in a troubled debt restructuring involving a modification of terms.

<sup>3</sup> Guidance from the FFIEC that has been reiterated in this letter was previously announced in the February 10, 1995 Federal Register.

Examiners should continue to focus primarily on the assessment of the adequacy of the overall ALLL.<sup>4</sup> While the allowances determined under FAS 114 should be considered by examiners in performing an evaluation of the adequacy of a bank's allowance, examiners should not focus unduly on the adequacy of this or any other portion of the ALLL established for a subset of loans.

Several other supervisory issues related to the implementation of FAS 114 and FAS 118 by banks are discussed below:

**Identifying loans to evaluate.** FAS 114 does not specify how a bank should identify loans that are to be evaluated for collectibility, but suggests that each bank should apply its normal loan review procedures. Simply identifying a loan as being subject to evaluation for collectibility, for example, by placing a loan on a "Watch List," does not necessarily mean that the loan is impaired.

As a GAAP standard, FAS 114 is generally intended to be applied on a consolidated basis. Some banks may be subsidiaries of holding companies that have chosen to identify loans for evaluation under FAS 114 on a consolidated holding company basis. In that event, the size threshold used for determining whether FAS 114 is applied to a loan may be so large that smaller subsidiary banks will have few or no loans identified for evaluation under FAS 114. Examiners should not take exception to this method of applying FAS 114 for Call Report purposes, provided that the same approach is used for financial reporting purposes and the bank continues to review credits that are large or significant to it (whether or not subject to FAS 114) on an individual basis when analyzing the adequacy of its ALLL.

**Collateral dependent loans.** A loan is considered "collateral dependent" when the repayment of the debt will be provided solely by the underlying collateral, and there are no other available and reliable sources of repayment. When determining the amount of impairment on a collateral dependent loan for purposes of reporting on Call Reports, the FFIEC decided that, consistent with the Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (November 1991, SR 91-24), institutions must base their determination on the fair value of the collateral. In addition, the FFIEC reiterated that any portion of the loan balance on a collateral dependent loan that exceeds

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<sup>4</sup> Consistent with existing policy as set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses, the ALLL should be adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend. To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.

the fair value of the collateral and that can be identified as uncollectible should generally be classified Loss and promptly charged off against the ALLL.

A collateralized loan that becomes impaired is not considered "collateral dependent" if repayment is available from reliable sources other than the collateral. Any impairment on such a loan may, at the bank's option, be determined based on the present value of the expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, on the loan's observable market price.

**Additional allowance on impaired loans.** Consistent with guidance issued by the FFIEC, the Federal Reserve will not automatically require an additional allowance for credit losses for impaired loans over and above what is required on these loans under FAS 114. However, an additional allowance on impaired loans may be necessary based on consideration of institution-specific factors, such as historical loss experience compared with estimates of such losses and concerns about the reliability of cash flow estimates, the quality of an institution's loan review function, and controls over its process for estimating its FAS 114 allowance. Of course, when an institution's reported ALLL does not meet the objectives for an adequate ALLL set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses, the institution should be required to restore the level of the ALLL to an adequate level as of the evaluation date.

**Charge-offs.** The FFIEC has recently reaffirmed existing supervisory policies that require banks to promptly charge off identified losses. Thus, when available information confirms that specific loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount), or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL, regardless of whether an allowance was established to recognize impairment under FAS 114. Any recoveries on loans or leases previously charged off should be credited to the ALLL.

**Income recognition.** FAS 118 amended FAS 114 to eliminate its income recognition provisions, and, thus, no FASB standard exists for income recognition on impaired loans. For supervisory purposes, and to ensure consistency in the recognition of interest income, the FFIEC decided to retain existing nonaccrual policies. As with all other loans, impaired loans should be reported as past due or nonaccrual loans in Call Report Schedule RC-N when meeting the definitions to these Call Report items. Since full collection of principal and interest is generally not expected for impaired loans, income accrual should normally be discontinued on such loans at the time that they first become impaired. Any cash payments received on impaired loans should be reported in accordance with the criteria for the cash basis recognition of income in the Glossary entry for "nonaccrual status" contained in the instructions to the Call Report.

**Classification.** An institution's adoption of FAS 114 for regulatory reporting purposes generally should not affect the examiner's classification of troubled loans. Examiners should continue to classify troubled loans, including any troubled collateral dependent loans, based on the definitions of Loss, Doubtful, and Substandard contained in the Federal Reserve's Commercial Bank Examination Manual and other supervisory guidance. If any loan is determined to be wholly or partially Loss, the amount of such Loss should be promptly charged off without regard to whether the loan is subject to FAS 114 or whether an allowance for estimated credit losses has been established in accordance with the standard.

**Regulatory reporting and disclosure.** Consistent with the decisions that FAS 114 sets forth methods for determining a portion of the overall ALLL and that examiners should primarily focus their attention on the adequacy of the overall ALLL, the FFIEC decided not to collect any new supervisory information in Call Reports with respect to FAS 114. Nonetheless, if a banking organization prepares GAAP financial statements, disclosures will be provided in the financial statements or accompanying notes about impaired loans and the allowance related to such loans. The examiner should consider reviewing these disclosures as part of the assessment of the adequacy of an institution's ALLL.

**Regulatory capital.** Consistent with determinations made by the FFIEC, the ALLL, including the part established in accordance with FAS 114, should continue to be reported net of any identified losses and be includible in Tier 2 capital, subject to current limits.<sup>5</sup>

As noted above, for additional examination guidance on the evaluation of the adequacy of the overall ALLL, please refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses (see SR 93-70) and to Section 2070.1 of the Commercial Bank Examination Manual, "Allowance for Loan and Lease Losses." Additional guidance with respect to commercial real estate loans is contained in the Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (SR 91-24). For further information on FAS 114 and its application for Call Report purposes, refer directly to FAS 114 and the Call Report glossary "Loan Impairment."

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<sup>5</sup> Under current risk-based capital guidelines, the amount of the ALLL qualifying in Tier 2 capital may not exceed 1.25 percent of risk-weighted assets.

If you have any questions on FAS 114 or the guidance contained herein, please call Charles Holm, Project Manager, Regulatory Reporting and Accounting Issues Section, at (202) 452-3502, Arthur Lindo, Supervisory Financial Analyst, Regulatory Reporting and Accounting Issues Section, at (202) 452-2695, or Kevin Bertsch, Supervisory Financial Analyst, Policy Development Section, at (202) 452-5265.



Richard Spillenkothen  
Director

Cross Reference: / SR 93-70  
SR 91-24  
Commercial Bank Examination Manual, Section 2070.1  
Bank Holding Company Manual, Sections 2010.7 and 2065.2