2012 Accounting & Auditing Roundtable

THE FEDERAL RESERVE BANK OF RICHMOND
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2012 Accounting & Auditing Roundtable

Hosted by the Federal Reserve Bank of Richmond
November 29, 2012

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Agenda

- Introductions
- Allowance for Loan and Lease Losses (ALLL): Trends, Current Issues, and Forthcoming Guidance
- Real Estate Accounting and Other Matters
- Deferred Tax Assets (DTAs): A Regulatory Perspective
- Other Miscellaneous Topics
  - Supplemental Policy Statement on The Internal Audit Function and Its Outsourcing
  - Recent Accounting Developments
- Closing Remarks

Today’s Discussion Leaders

Terrill L. Garrison, Jr., CPA
Board of Governors of the Federal Reserve
Banking Supervision & Regulation’s
Accounting Policy & Disclosure Section

David W. Powers, CPA
Federal Reserve Bank of Richmond’s
Supervision, Regulation & Credit’s
Community & Regional Unit

David C. Schwartz, CPA
Federal Reserve Bank of Richmond’s
Supervision, Regulation & Credit’s
Risk & Policy Unit’s Credit & Accounting Team

Jon Tkach, CPA
Board of Governors of the Federal Reserve
Banking Supervision & Regulation’s
Accounting Policy & Disclosure Section

Jeffery T. Zajac
Federal Reserve Bank of Richmond’s
Supervision, Regulation & Credit’s
Risk & Policy Unit’s Credit & Accounting Team

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Allowance for Loan and Lease Losses (ALLL): Trends, Current Issues, and Forthcoming Guidance

David C. Schwartz, CPA
Credit Risk & Accounting Policy Specialist
Federal Reserve Bank of Richmond

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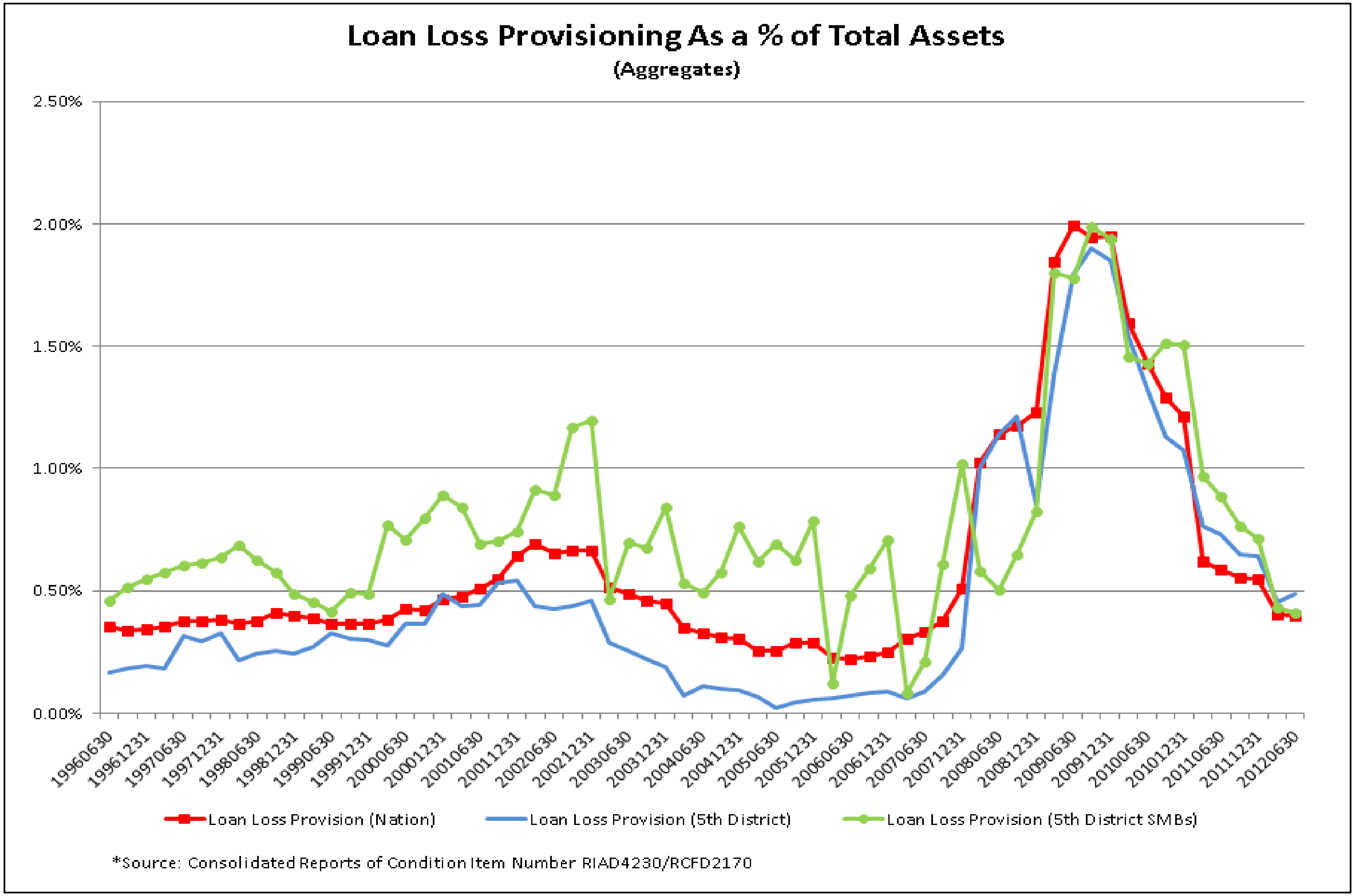
ALLL - Agenda

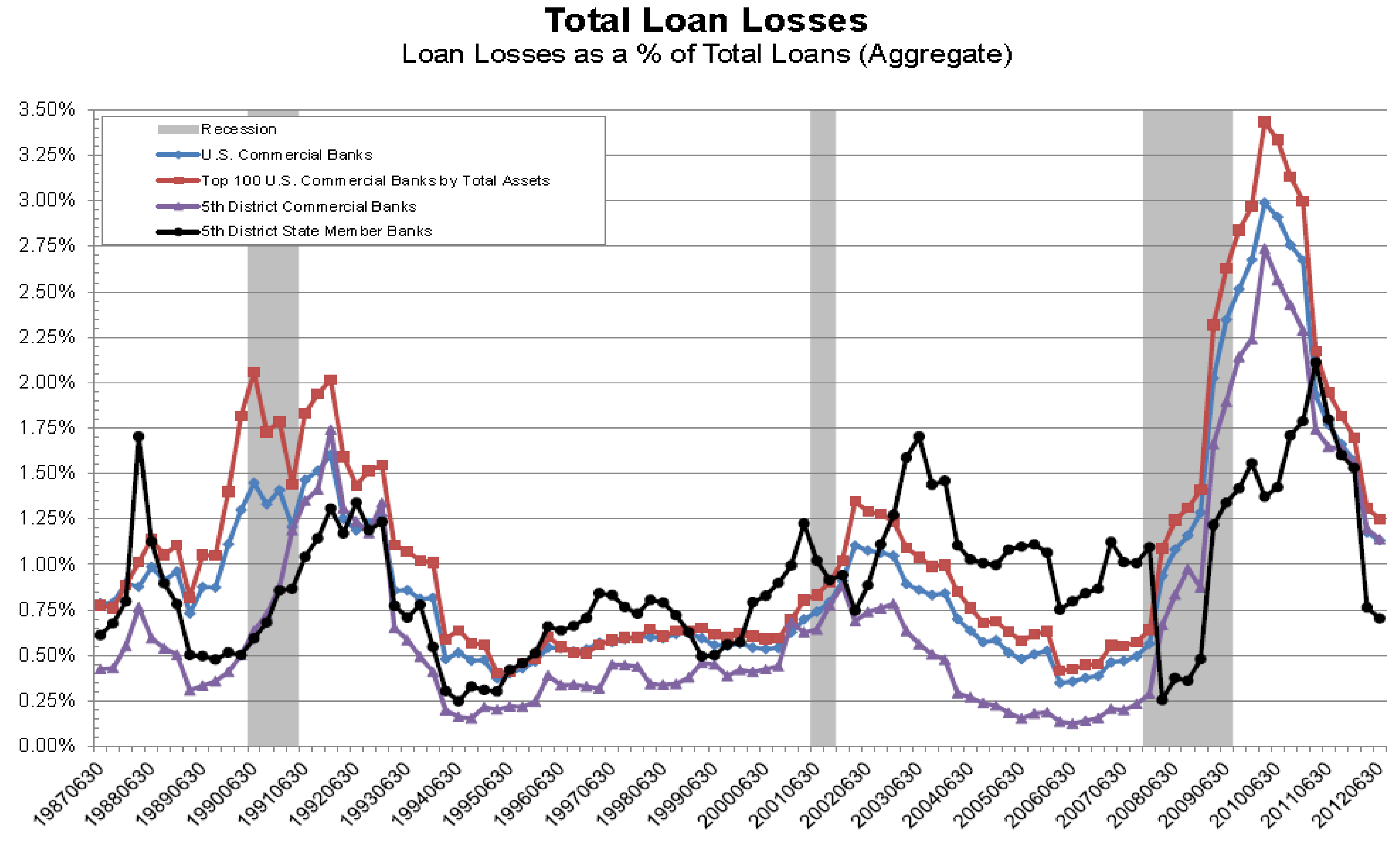
- ALLL Levels and Trends
- ALLL Current Issues
- Examination of ALLL & Common Exam Issues
- Forthcoming TDR Guidance

Allowance for Loan and Lease Losses (ALLL): Trends

Provisions Continue to Decline

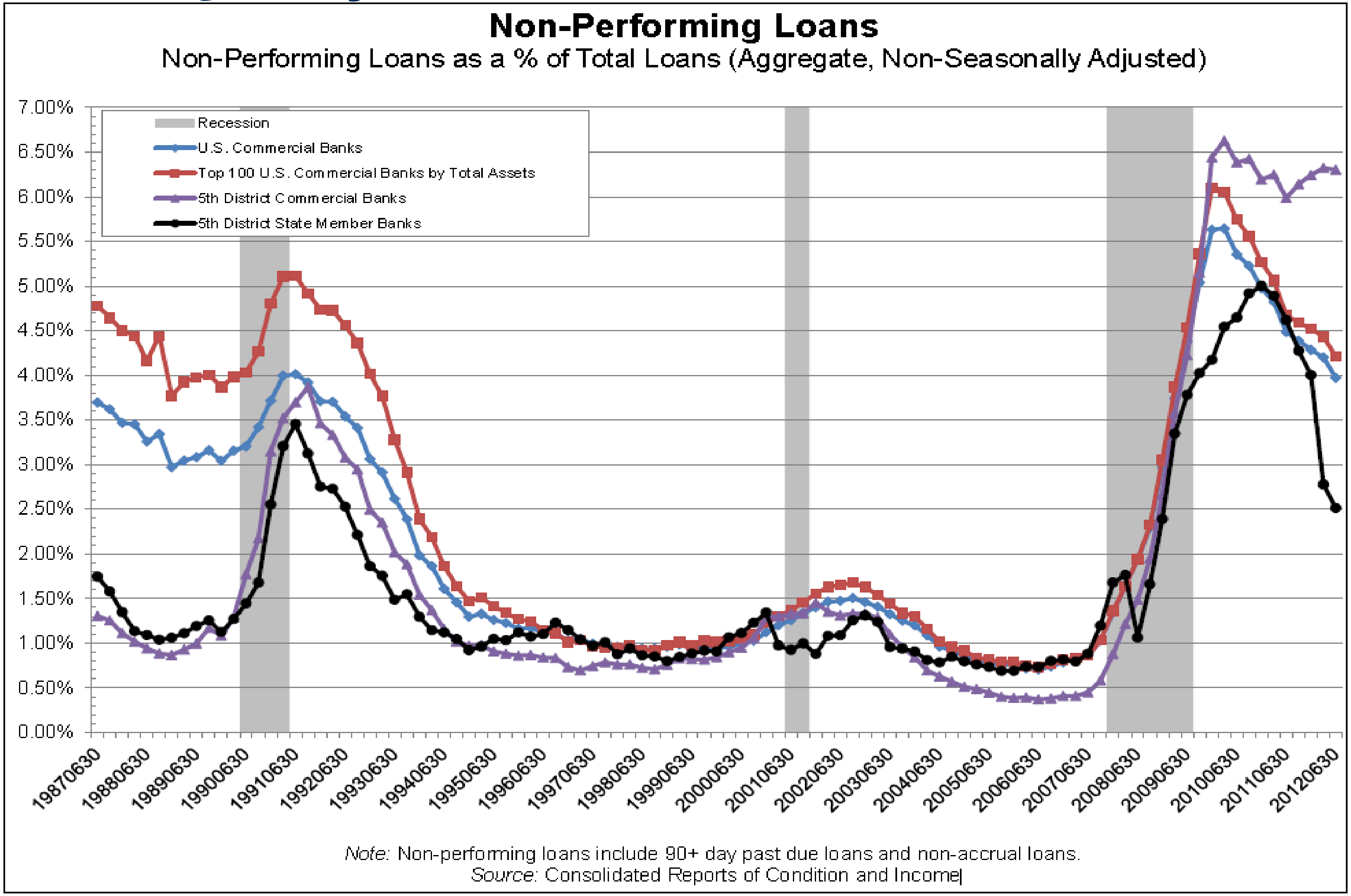


Loan Losses Continue to Decline



Note: Total loan losses defined as charge-offs minus recoveries.
Source: Consolidated Reports of Condition and Income

Credit Quality Concerns Remain Elevated



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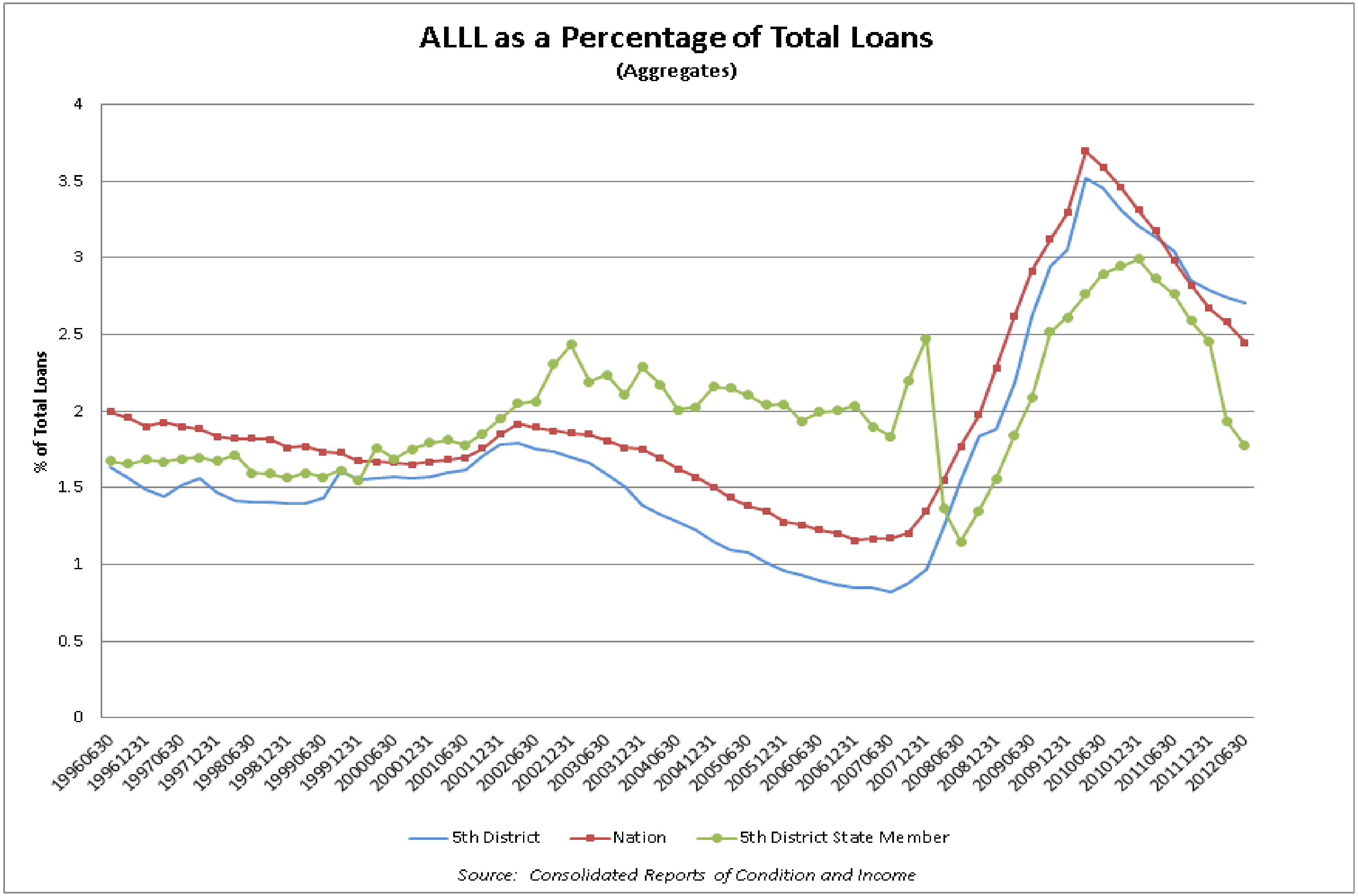
ALLL Levels Continue to Decline



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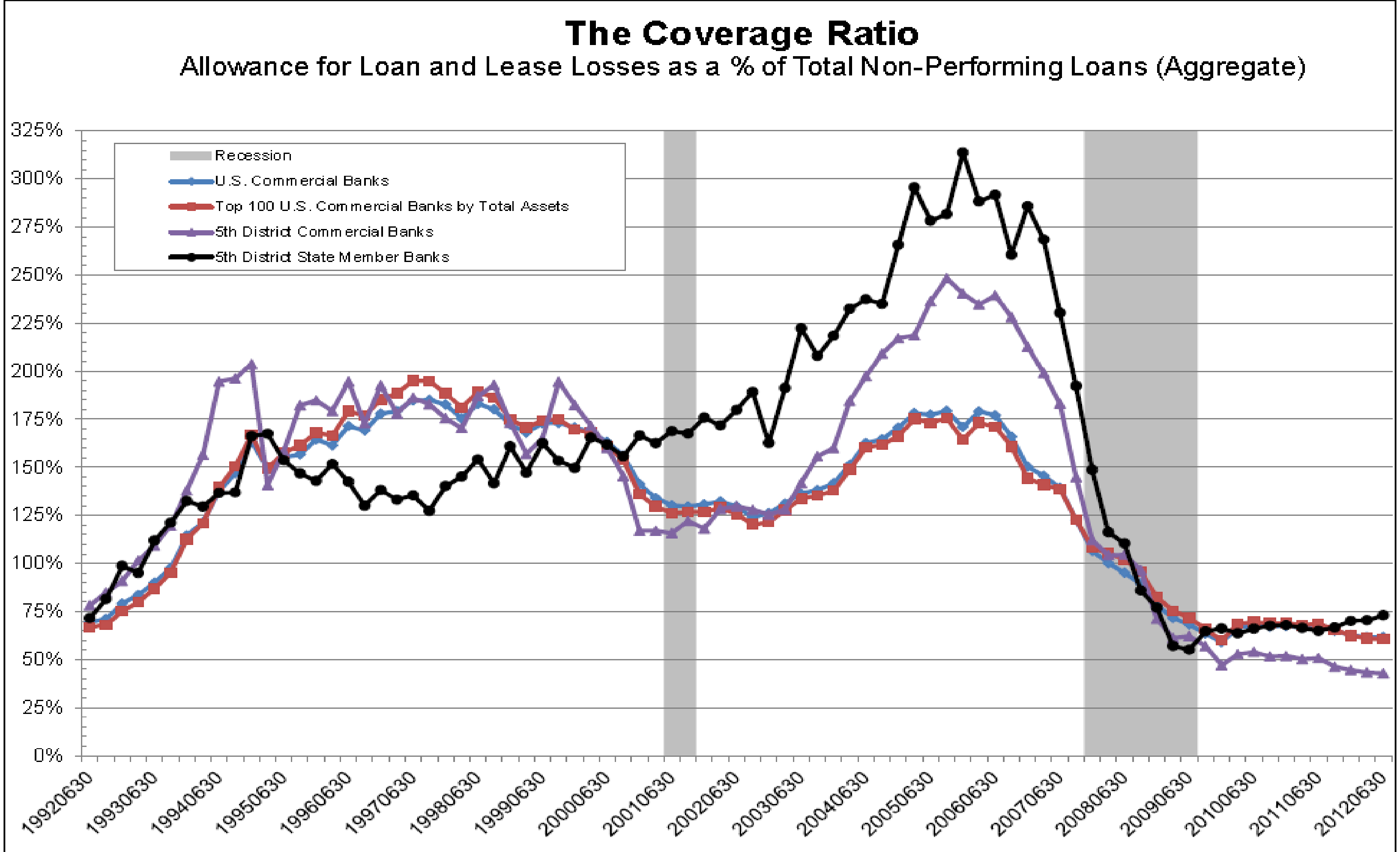
Coverage Ratio at Historic Lows



Note: Non-performing loans include 90+ day past due loans and non-accrual loans.
Source: Consolidated Reports of Condition and Income

Allowance for Loan and Lease Losses (ALLL): Current Issues

Current Issues

- Pace and magnitude of ALLL releases
- Look-back periods for calculating loss rates
- Qualitative factors
- Unallocated reserves
- Calculation of ALLL on junior lien portfolios
- Impairment measurement
- Nonaccrual vs. impaired

ALLL Releases – Credit Risk

- Recent trends in certain credit quality indicators show improvement – but risks remain elevated
- Yield and earnings pressure
  - Potential impact on underwriting standards
  - Expansion into new and/or less familiar products
- CRE risk remains elevated
- Home equity payment shocks

ALLL Releases – Meetings with Auditors and Regulatory Agencies

- Meeting with SEC, PCAOB, External Auditors, and Regulatory Agencies
- Ensured common understanding
- SEC & PCAOB comments related to the adequacy of documentation and <u>not</u> the amount of the allowance

ALLL Releases - Examiner Focus

- Ensuring ALLL is established in accordance with GAAP and supervisory guidance
- Approaching significant decreases in the ALLL with caution
- Review evidence of solid trends
- Ensuring all available information is taken into account
- Review of documentation & support

ALLL Current Issues: Loss History

- What is the appropriate time horizon for calculating historical loss rates?
  - Supporting documentation should include an analysis of how the current conditions compare with those conditions during the period used in the historical loss rates for each group of loans assessed under ASC 450-20
- Banks should review the range of historical losses
  - Identify and document the appropriate historical loss rate from within the range

GAAP does not prescribe a fixed period of time that banks should use for their historical loss experience.

ALLL Current Issues: Qualitative Factors

- Management is expected to consider factors likely to cause estimated credit losses associated with the institution's existing portfolio to differ from historical loss experiences.
  - Choice of factors requires professional judgment
  - Management should document qualitative factors considered and conclusions reached

ALLL Current Issues: Qualitative Factors (cont.)

- Documentation & Support – Examiners Focus
  - Does the documentation exist?
  - Is the documentation reasonable?
  - Did management adequately identify the qualitative factors that are determined to cause losses to differ from historical rates?
  - Is there directional consistency between the loss estimates and the underlying factors?

ALLL Current Issues: Qualitative Factors (cont.)

- Documentation & Support
  - Description of factors
  - Management's analysis of how each factor has changed over time
  - Which loan groups' loss rates have been adjusted
  - The amount by which loss estimates have been adjusted for changes in conditions
- Examples of Support
  - Articles describing economic events impacting a particular geographic area and/or industry
  - Economic data and reports
  - Notes from discussions with borrowers

ALLL Current Issues: Unallocated

- Acceptable if in conformity with GAAP
  - Not defined in GAAP
- Must be properly supported and documented
- No threshold for size

Not to be used as a cushion or to reach a desired number

ALLL Current Issues: Junior Liens

- SR Letter 12-3: Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit
  - Supplements existing guidance (May 2005 Interagency Guidance on Home Equity Lending)
  - Directed towards institutions with significant portfolios; applies to all banks, including those with less than $10 billion in consolidated assets

Institutions should ensure that sufficient information is gathered to adequately assess the probable loss incurred within junior lien portfolios.

ALLL Current Issues: Junior Liens (cont.)

- **Reminds Institutions to:**
  - Gather & analyze data on the associated senior lien loans
  - Periodically refresh relevant credit quality indicators
  - Incorporate credit quality data into the allowance estimation process by segmenting the portfolio or establishing a qualitative allowance.

ALLL Current Issues: Impairment Measurement

- For impaired loans including TDRs, a creditor shall measure impairment based on the
  - **present value of expected future cash flows** discounted at the loan's effective interest rate
  - except that as a practical expedient, a creditor may measure impairment based on:
    - a **loan's observable market price**, or
    - the **fair value of the collateral** if the loan is a collateral-dependent loan.

The Call Report requires that the measure for loss of impaired collateral dependent loans be based upon the fair value of the collateral (less cost to sell).

ALLL Current Issues: Nonaccrual vs. Impaired

Nonaccrual & Impaired Loans: An Illustrative Discussion

The following illustration is provided to highlight the differences and similarities between impaired and nonaccrual loans. While both terms have their basis in generally accepted accounting principals (GAAP), nonaccrual/accrual status is largely driven by regulatory accounting principles. See page two for examples and sources of guidance.

Nonaccrual: Regulatory guidance - Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.**

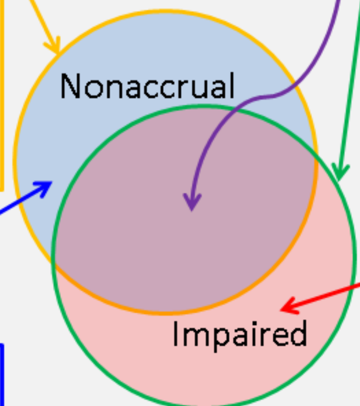
Exceptions Apply see the pink box "Impaired & Accruing" for additional details

[For troubled debt restructurings (TDRs) accrual status is based upon the modified terms not the original loan terms.]

***In process of collection requires that the collection is proceeding in due course either through legal action or other collection efforts which are reasonably expected to result in repayment or restoration to a current status in the near future. (In practice, the other regulatory agencies consider near term as either within 30 days (OCC) or the next Call Report date (FDIC).)*

Nonaccrual & impaired: Most loans that are on nonaccrual will have characteristics of an impaired loan (and vice versa). Although exceptions may apply, a loan that is not already in nonaccrual status when it is first identified as impaired will normally meet the criteria for placement in nonaccrual status at that time.

Impaired: Accounting guidance - 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 according to the contractual terms of the loan agreement. "All amounts due according to the contractual terms" means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement; scope exceptions are provided for insignificant delays or shortfalls. *[For TDRs impairment is based on the original loan terms not the modified loan terms.]*



Impaired & Accruing: This would encompass a variety of situations including:

1. **Exceptions to the nonaccrual general rule for:**
   - Purchased impaired loans;
   - Consumer loans **or** loans secured by a 1-to-4 family residential property;
   - Assets for which the criteria for amortization specified in AICPA Practice Bulletin No. 6 are met with respect to a loan or other debt instrument (accounted for in accordance with that Practice Bulletin) that was acquired at a discount from an unaffiliated third party, including those that the seller had maintained on nonaccrual status.
2. **Well secured and in the process of collection:** Loans that are well secured and in the process of collection do not need to be maintained on nonaccrual status (see #3 in Nonaccrual); however, such loans may still be considered impaired.
3. **Payment in full vs. paying as agreed:** Full payment of principal and interest is expected; however, the borrower is materially not paying according to the contractual terms (see red highlighted text in the "Nonaccrual" and "Impaired" boxes).
4. **Loans returned to accrual status but still impaired:**
   - Borrower is paying as agreed, even though the loan is not fully current and the following conditions are met:
     - All P&I contractually due (including arrearages) are reasonably assured of repayment within a reasonable period; and
     - There is a sustained period of repayment performance by the borrower in accordance with the contractual terms;
   - The loan has been returned to accrual status when none of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest; or when the loan otherwise becomes well secured and in the process of collection;
   - Formally restructured (TDR) loans that qualify for accrual status [Accrual status would be based on the modified terms, while impairment is based on the original loan terms].

Nonaccrual & Non-impaired: This situation would be rare, but would primarily arise due to differences between the strict application of regulatory & accounting guidance such as:

1. Loans **maintained on a cash basis** due to deterioration in the financial condition of the borrower are considered nonaccrual; in rare instances these loans may not yet be deemed impaired under accounting guidance.
2. Exception for **insignificant delays** in the timing of payments afforded by GAAP, but not similarly provided for in RAP.

This document does not constitute official policy of the Federal Reserve Bank of Richmond or the Board of Governors of the Federal Reserve System and is neither binding on the Federal Reserve nor a substitute for users' exercise of appropriate judgment and analysis of actual circumstances. Users should consult the actual policies for specific guidance.

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ALLL Current Issues: NA vs. Impaired (cont.)

Nonaccrual & Impaired Loans: Examples

Nonaccrual & impaired: A loan with a borrower is past due on principal and interest. The bank does not expect to receive payment in full of principal and interest. The bank places the loan on nonaccrual and evaluates the loan for impairment and properly reserves for the loan.

Impaired & Accruing: A $10 million loan was secured by income producing real estate. As of January 1, 2010 the loan was over 90 days past due with respect to interest and principal; the bank had determined the loan to be impaired and the loan was placed on nonaccrual. Cash flows are sufficient to service only a $9 million dollar loan at a current market rate of interest. As such, the bank determines the best course of action is to restructure the loan via a troubled debt restructuring. On March 31, 2010 the bank restructures the loan by splitting it into two separate notes. Note A is for $9 million. It is collateral dependent and carries a current market rate of interest. Note B is for $1 million, and carries a below-market rate of interest. The bank charges off all of Note B, but does not forgive it. On November 1, 2010, following six months of payment performance and further analysis, the bank returns the A note to accrual status as the bank determined that the borrower has the ability to repay the loan, has a record of performing at the revised terms, and full repayment of principal and interest is now expected. However as impairment is based on the original loan terms, not the revised loan terms, the loan is still considered impaired.

Nonaccrual & Non-impaired: While it is theoretically possible to have a loan that will not be impaired but would be identified as nonaccrual, practically speaking it is difficult to think of a realistic example. If the Venn diagram on the prior page were drawn to scale, the blue shaded portion of the diagram would be so small it would be barely visible. That said, as professional judgment is required in the application of accounting and regulatory guidance, the following example could result in a loan being considered both nonaccrual and non-impaired.

A furniture manufacturer has a 10 year $2,000,000 amortizing loan that has been paying as agreed for the last 8 years. Due to a flood at the borrower's corporate offices, the borrower's bookkeeping function has been temporarily disrupted; the borrower's manufacturing operations was not impacted and continues to produce, sell and ship the furniture to retail outlets. However, due to the flood impacting its bookkeeping operations, the borrower failed to make its last three monthly payments. After conversations with the borrower it was clear to the banker that the back payments would be paid within the month as the restoration of the bookkeeping function was nearly complete. The banker considers the delay in payments insignificant for accounting purposes and does not consider the loan impaired. However, as the loan is currently greater than 90 days past due, the bank's accounting system has automatically placed this loan on nonaccrual for regulatory reporting purposes.

Nonaccrual & Impaired Loans: Sources of Guidance*

Nonaccrual: Call Report/FR Y9C instructions glossary entry for "Nonaccrual Status"

Impaired: Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 310-10-35-16 Receivables – Overall – Subsequent Measurement

Nonaccrual & impaired: Call Report/FR Y9C instructions glossary entry for "Loan Impairment"

Impaired & Accruing: Call Report/FR Y9C instructions glossary entries for "Nonaccrual Status", and "Loan Impairment." FASB's ASC 310-40-35-12 Receivables – Troubled Debt Restructurings by Creditors – Subsequent Measurement

Nonaccrual & Non-impaired: Call Report/FR Y9C instructions glossary entry for "Nonaccrual Status", and FASB's ASC 310-10-35-17 Receivables – Overall – Subsequent Measurement, and ASC 310-10-35 Receivables – Overall – Subsequent Measurement

**This is not a complete list of related guidance, only those sources used to support the statements found on the prior page.*

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Allowance for Loan and Lease Losses (ALLL): Examination of the ALLL & Common Exam Issues

Examination of the ALLL

- **Methodology is examined for reasonableness**
  - If necessary, examiners will direct management to make adjustments to the methodology based upon institution specific information.
  - Examiners will only use proxies in rare circumstances when the institution's methodology cannot be accepted
- **Qualitative Factors**
  - Review documentation for reasonableness
  - Review to ensure qualitative factors include items that affect collectability that are not otherwise captured in loss history.
  - Review to ensure that factors are identified at an appropriately segmented level

Examination of the ALLL (cont.)

- **What happens when the methodology is unacceptable?**
  - Examiners will require that the ALLL methodology be changed in order to comply with GAAP.
  - In the short term, institutions will be required to record an allowance based upon an examiner proxy.
  - In calculating a proxy, consideration will be given to collateral coverage of problem loans.
  - Examiners will require methodology to be corrected and available for review by the following quarter.

ALLL: Common Exam Issues

- **Collateral values** – outdated appraisals, incomplete appraisals, failure to take into account costs to sell, arbitrary application of discount percentage
- **Appraisal review process –** lack of effective appraisal review processes, staff not properly experienced to identify issues and inappropriate assumptions
- **Qualitative factors** – lack of support and documentation
- **Look back periods & historical loss rates** – not taking into account appropriate experience, application of generic loss rates

ALLL: Common Exam Issues (cont.)

- **Qualitative factors vs. look back periods –** adjusting the look back period instead of adding/adjusting a qualitative factor
- **ASC 450 Pools** – Lack of proper segmentation
  - Lack of proper segmentation for junior lien loans
- **Artificial caps or floors** on ALLL
- **Nonaccrual determination –** relying only on past due status
- **Impaired loans** – inconsistent application of the definition of "impaired"

Allowance for Loan and Lease Losses (ALLL): Forthcoming TDR Guidance

Forthcoming Guidance on TDRs

- Interagency Guidance on Troubled Debt Restructurings (TDRs)
  - Clarifying supervisory guidance
  - Companion Q&A
    - FAQs
    - Responds to more specific questions

If conducted in a prudent manner, modifications are in the best interest of both the institution and the borrower and are viewed positively by the regulatory agencies.

Forthcoming TDR Guidance: Expected Content

- **Accrual status**
  - Not all TDRs are nonaccrual
  - TDRs need not be kept on nonaccrual status over their life
  - TDRs can be maintained on accrual status at the time of the modification
- **Classification**
  - TDR designation does not automatically translate into an adverse classification
  - TDRs adversely classified at the time of the modification are not expected to remain adversely classified over their life

Forthcoming TDR Guidance: Expected Content (cont.)

- **When is a loan considered collateral dependent?**
  - Includes loans repaid solely through operation of the collateral
    - What is solely?
  - Guarantors should be considered when evaluating whether a loan is collateral dependent
  - Includes income-producing property where repayment of the loan will come solely from the collateral
- **Charge-offs**
  - Clarify when charge-offs are required for regulatory purposes and how to determine the amount of the charge-off

Forthcoming TDR Guidance: Expected Content (cont.)

- **Treatment of capitalized costs**
  - Disbursements to protect a bank's collateral position can be capitalized
- **Modifications of loans facing payment shock**
  - For any modification of a loan facing payment shock (for example HELOCs converting to amortizing loans) a bank must evaluate whether the modification meets the criteria of a TDR.
- **Substandard loans**
  - Substandard loans that are on accrual that are renewed, extended or otherwise modified are not automatically considered TDRs.

Real Estate Accounting and Other Matters

Jon Tkach, CPA
Board of Governors of the Federal Reserve
Banking Supervision & Regulation's
Accounting Policy & Disclosure Section

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Agenda

- Real estate: review of accounting and supervisory frameworks
- OREO-to-rental initiatives and related accounting and reporting considerations
- Sale and transfer of OREO: initial and ongoing accounting and reporting considerations
- Accounting for mortgage repurchase requests

Real Estate: Review of Accounting and Supervisory Frameworks

OREO Accounting Framework

- Accounting for and reporting of OREO under U.S. GAAP falls under ASC Topic 360
- Classified and accounted for as either:
    i. "held and used" or
    ii. "held-for-sale"
- Under U.S. GAAP, presumption that long lived assets, including OREO, are **held and used** unless six conditions in ASC 360-10-45-9 are met
- If held and used, initially measured at cost and subsequently depreciated and subject to impairment under long-lived asset test

OREO Accounting Framework (cont.)

- If held for sale, initially measured at fair value less cost to sell and subsequently at lower of:
  1. carrying amount, or
  2. fair value less cost to sell
- Accounting for sales and transfers of OREO covered by ASC 360-20
  - Full accrual method, or
  - When application of full accrual method is not appropriate, four methods for recognizing profit

OREO Regulatory Reporting Framework

- An asset is re-characterized from a loan to OREO in regulatory reports when an institution takes physical possession, regardless of whether formal foreclosure proceedings have taken place
- Bank regulatory reporting instructions include a rebuttable presumption that a long-lived asset acquired from a borrower in satisfaction of a loan is “held-for-sale”
- The bank regulatory agencies’ reporting requirements are consistent with the guidance originally in AICPA Statement of Position No. 92-3, "Accounting for Foreclosed Assets", which included a rebuttable “held-for-sale” presumption
- Possible that the accounting for OREO under U.S. GAAP and BHC regulatory reporting could differ

OREO Regulatory Reporting Framework (cont.)

- The write-down of OREO can be recognized as a valuation allowance against the asset, created through a charge to earnings:
  - Optional use of a valuation allowance
  - Subsequently, increase or decrease of valuation allowance (but not below zero) for changes in the asset's fair value, or cost to sell
- Operating income related to OREO (e.g., gross rentals) is reported as other noninterest income, while operating expenses (e.g., property taxes, insurance, maintenance costs) are reported as other noninterest expenses

OREO Regulatory Reporting Framework (cont.)

Classification of OREO in regulatory reports:

- At time of transfer:
  - Valuation of OREO asset
  - Loss is recognized through the allowance for loan and lease losses (ALLL)
  - OREO asset, given its well-defined weaknesses, should be adversely classified
- During holding period
  - Decrease in the OREO asset's fair value less cost to sell is considered a loss
  - OREO asset would continue to be adversely classified

OREO Regulatory Reporting Framework (cont.)

Classification of OREO in regulatory reports cont'd

- Pending sale
  - Adversely classified but may be classified "pass" under certain conditions:
    - A firm contract is in place that contemplates a sale in the reasonably near future
    - Sale proceeds cover carrying value
    - Purchaser has the financial resources to complete the purchase
    - Bank has no contingent liability
- Other considerations
  - OREO residential rental asset classified as "pass" when the lease reflects a reasonable rate of return (refer to SR letter 12-5/CA letter 12-3, "Policy Statement on Rental of Residential OREO Properties")

OREO-to-Rental Considerations

OREO-to-Rental Considerations

- Federal Reserve policy statement on OREO (SR 12-5) did not intend to change bank accounting and reporting practices for OREO
- Rather, SR 12-5 was intended to reinforce the Federal Reserve's general policy that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date
  - It also communicates that such organizations are permitted to rent residential OREO properties within statutory and regulatory holding period limits **without the burden of demonstrating continuous active marketing of the property**
  - Laws, regulations, and the expectations of other functional supervisory regarding marketing requirements may vary depending on the type of charter an institution holds
  - Guidance **did not** intend to permit banking organizations to engage in the rental of OREO assets outside of a safe and sound disposition strategy

OREO-to-Rental Considerations (cont.)

- In addition, SR 12-5 provided risk management guidance for banking organizations that engage in the rental of residential OREO assets
  - Requires banking organizations to have an operational framework for their residential OREO rental activities that is appropriate based on scale of such activities
  - Outlines supervisory expectations for institutions that engage in large-scale residential real estate rental operations

Accounting for Sales of OREO

Accounting for Sales of OREO

- Outright sales with no lender continuing involvement (i.e., sale financed by an unrelated party)
  - Account for transfer as a sale when title passes with full profit recognition
- Transactions in which the seller provides financing to the buyer of the real estate are more complicated.
- U.S. GAAP provides five methods to account for the disposition of real estate:
  - Full Accrual, Installment, Cost Recovery, Reduced Profit, Deposit
- Losses on sale can not be deferred

Accounting for Sales of OREO (cont.)

- Examples of circumstances where the sale of OREO does not result in a sale for accounting purposes include, but are not limited to, the following:
  - Initial investment is inadequate and recovery of the cost of the property is not assured
  - Continuing involvement in the OREO asset
- The sale of OREO to a related party must be recorded at fair value:
  - Must also comply with the market terms requirement of Regulation W

SR 12-10: Q&A on OREO

- In June 2012, the Federal Reserve Board issued SR letter 12-10/CA letter 12-9, "Questions and Answers for Federal-Reserve Regulated Institutions Related to the Management of Other Real Estate Owned (OREO)"
- Topics covered in the Q&A document:
  - Financial reporting
  - Loss recognition
  - Management of OREO assets
  - Consumer protection issues
- Q&A is intended to address both safety and soundness and consumer compliance issues.

Accounting for Mortgage Repurchase Requests

Mortgage Repurchase Requests

- Since the recent economic recession, the volume of mortgage buyback / repurchase demands continues at unprecedented levels
- Driven by defaulted loans due to poor underwriting standards as well as breaches of less significant representations and warranties
- Per the Mortgage Bankers Association, during the three years preceding 12/31/2011, Fannie Mae and Freddie Mac have made close to $100 billion in repurchase demands
- Uncertainty of mortgage repurchase requests within seasoned and new pools sold (including to Fannie Mae and Freddie Mac) in the current environment creates a challenge for financial accounting and reporting
  - ASC 450-20 requires recognition of loss contingency when both *probable and reasonably estimable*

Mortgage Repurchase Requests (cont.)

- Questions continue to be raised as to what portion of a bank's potential exposure to mortgage repurchase requests must be recorded in the financial statements and how to estimate such exposure
- Process to estimate exposure to mortgage repurchase requests involves significant judgment – in most cases underwriting-related exposure is bank specific
  - High correlation between repurchase exposure and default statistics
- For seasoned pools banks should accrue for repurchase requests triggered from poor underwriting standards and other breaches based on actual pool statistics or comparable pool statistics (e.g., peer data)
- For new pools, banks can use statistics from comparable seasoned pools adjusted for changes in underwriting standards and default rates
- Recognition threshold may exist at date of transfer but ultimately depends on bank's individual circumstances

Deferred Tax Assets

David W. Powers, CPA
Federal Reserve Bank of Richmond's
Supervision, Regulation & Credit's
Community & Regional Unit

Jeffery T. Zajac
Federal Reserve Bank of Richmond's
Supervision, Regulation & Credit's
Risk & Policy Unit's Credit & Accounting Team

Agenda – Deferred Tax Assets

- Principal Guidance
- GAAP Summary
- Review of Deferred Tax Assets
  - Valuation
  - Valuation Releases
  - DTA Capital Limits
  - Examiner Viewpoint
- FAQs

Principal Guidance

- GAAP
  - Principal GAAP guidance is FASB's ASC 740, *Income Taxes* (formerly FASB Statement No. 109)
- Regulatory Reporting
  - Call Report and FR Y-9C Report
    - Glossary – Income Taxes
    - Regulatory Capital Schedule (RC-R/HC-R)
  - Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure
    - www.federalreserve.gov/boarddocs/srletters/1998/SR9838

GAAP Summary

- Temporary differences arise when events are recognized in one period on a bank's books but are recognized in another period on its tax return
  - Result in reporting of income or expense in different periods in income statement and tax returns
  - Two types:
    - Deductible temporary differences
    - Taxable temporary differences

GAAP Summary

Deductible temporary differences reduce taxable income in future periods and create deferred tax assets (DTAs)

- Example – the provision for loan and lease losses is expensed for book purposes in one period but cannot be deducted for tax purposes until the loans (or portion of the loans) are considered worthless (i.e. when charged-off)

Taxable temporary differences result in additional taxable income in future periods and create deferred tax liabilities (DTLs)

- Example – goodwill acquired in a taxable purchase business combination is amortized (and deductible) for tax purposes, but not for book purposes unless impaired

Note: *Net operating loss carryforwards also create deferred tax assets*

Review of Deferred Tax Assets

Focus Areas

- Valuation Allowance
- Valuation Allowance Releases
- Regulatory Capital
- Examiner Review of Deferred Tax Assets

Valuation Allowance

- The realizability of all DTAs must be evaluated each period. A valuation allowance must be recorded, if needed, for amounts that are not likely to be realized **(e.g., > 50 percent probability)**.
- Examiners will consider all available evidence, both positive and negative, in assessing the need for a valuation allowance.
- Realization of DTAs depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary versus capital) in either the carryback or carryforward period.

Valuation Allowance Releases

- Requires judgment based on the facts and circumstances:
  - Look at both positive and negative evidence.
  - Forming a conclusion that valuation allowance is not needed is difficult when there is negative evidence, such as cumulative losses in recent years and the institution has not returned to profitability.
- Examiners will closely examine the institution's ability to generate pre-tax profits in evaluating management's decision to reverse a deferred tax asset valuation allowance.

Valuation Allowance Releases (continued)

- Examiners will increase their skepticism when realization of DTAs is only based on forecasted taxable income and evaluate how well the bank has forecasted income in the past.
- If an institution has an external auditor, examiners should understand what positive and negative evidence the auditors considered in concluding that the institution was likely to realize its DTAs.
- It is difficult for examiners to conclude the bank inappropriately reversed a DTA valuation allowance due to judgment involved.

Deferred Tax Asset Limits

Deduct from Tier 1 capital the amount by which DTAs dependent on future taxable income exceed the lesser of:

- Amount of DTAs the bank expects to realize within one year based on projected future taxable income for that year, or
- 10% of the bank's Tier 1 capital before deducting certain disallowed assets

Calculation of limit should be made on a separate entity basis

- Treat bank (plus its consolidated subsidiaries) that is a subsidiary of a holding company as a separate taxpayer rather than as part of a consolidated group

Deferred Tax Asset Limits

Regulatory capital adequacy guidelines limit DTAs and require amounts in excess of the limit to be deducted from regulatory capital

Limit **applies** to DTAs that are *dependent on future taxable income*:

- DTAs arising from deductible temporary differences that exceed taxes previously paid that could be recovered through loss carrybacks if all temporary differences (both deductible and taxable) <u>fully reverse at the report date</u>

Limit does **not** apply to:

- DTAs which can be realized from taxes paid in prior years
- Deferred tax effects of (i) unrealized holding gains and loss on AFS debt securities and (ii) defined benefit post-retirement plans (at the bank's option but must be applied consistently)

Examiner Review of Deferred Tax Assets

- Guidance Utilized
  - FASB's ASC 740, *Income Taxes* (formerly FASB Statement No. 109)
  - Call Report (RC-R) and FR Y-9C Report (HC-R)
  - Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure
- Documentation
  - Listing of deferred tax assets and liabilities that support net deferred tax balance
  - Information that support timing of realization
  - Release analysis and supporting documentation

Frequently Asked Questions

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If an institution has a 3-year cumulative pre-tax book loss, shouldn't they automatically have a valuation allowance?

- No. Industry practice has been to use 3-year cumulative pre-tax book losses as a proxy for "cumulative losses" as discussed in GAAP. If they have 3-year book losses, the analysis should focus on whether the institution had taxable income or losses because realizability of DTAs will ultimately depend on the existence of sufficient taxable income in either the carryback or carryforward period.

Frequently Asked Questions

If an institution is troubled, shouldn't there automatically be a valuation allowance under GAAP?

- No. Since GAAP sets the threshold at "more likely than not (a likelihood >50%)" and the carryforward period is generally 20 years, if the auditors expect the institution to continue as a going concern, it could be possible that no valuation allowance is necessary under GAAP. However, if an auditor does not expect the institution to continue as a going concern there will likely be a valuation allowance. If not, the audit firm should be consulted to determine why no valuation allowance was deemed necessary under these circumstances.

Frequently Asked Questions

If an institution is close to failing, should we routinely classify all DTAs as “loss” and have the institution write them off?

- Not necessarily. Before we classify all, or a significant portion, of the DTAs, we would need to determine that there is sufficient negative evidence about the realizability of the DTAs. Even an institution that is close to failing may have carryback potential that would allow it to realize DTAs on its final tax return.

Frequently Asked Questions

If a bank experiences taxable losses on a separate entity basis but the holding company does not have the funds to pay the refund to the bank, how should this be treated?

- If a refund is not made to the bank within a reasonable period following the date the bank would have filed its own return, regardless of whether the consolidated group is receiving a refund, the bank's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent (See SR 98-38).

Frequently Asked Questions

Under what circumstances can an institution reverse a valuation allowance previously established against a deferred tax asset?

- It depends on the facts and circumstances. Examiners should closely examine the institution's ability to generate pre-tax profits in evaluating management's decision to reverse a deferred tax asset valuation allowance. Examiners should increase their skepticism when profit projections are only based on a forecast and evaluate how well the bank has forecasted income in the past.

Supplemental Policy Statement on The Internal Audit Function and Its Outsourcing

Terrill L. Garrison, Jr., CPA
Sr. Accounting Policy Analyst
Board of Governors of the Federal Reserve
Banking Supervision & Regulation'
Accounting Policy & Disclosure Section

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Supplemental Policy Letter on Audit – SR 12-xx

- Federal Reserve Supplemental Policy Statement on "The Internal Audit Function and its Outsourcing"
  - Supplement to Interagency Policy Statement "SR Letter 03-05"
- Applies to:
  - Federal Reserve supervised institutions, including bank and savings and loan holding companies and U.S. operations of foreign banking organizations, with total consolidated assets of $10 billion or more.

Supplemental Policy Letter on Audit – SR 12-xx (cont.)

- Supplemental policy statement reflects:
  - Enhancements to the internal audit function post-crisis
  - Clarifying guidance pertaining to the attributes, governance, and operational effectiveness of an institution's internal audit function
  - Changes to banking rules
  - Additional examiner guidance
  - No changes to previous outsourcing guidance

Enhanced Internal Audit Practices
Six Key Areas

- Risk analysis
- Thematic control issues
- Challenging management and policy
- Infrastructure
- Risk Tolerance
- Governance and Strategy

Key Aspects of the Internal Audit Function - *Attributes*

- Independence
- Professional Competence and Staffing
- Objectivity and Ethics
- Internal Audit Charter

Key Aspects of the Internal Audit Function – *Corporate Governance*

- Board of Directors and Senior Management Responsibilities
- Audit Committee Responsibilities
- Role of the Chief Audit Executive

Key Aspects of the Internal Audit Function – *The Adequacy of Processes*

- Audit Methodology
- Audit Universe
- Internal Audit Risk Assessment
- Internal Audit Plan
- Continuous Monitoring

Key Aspects of the Internal Audit Function – *Performance and Monitoring Processes*

- Performance
  - Internal Audit Scope
  - Internal Audit Work Papers
  - Audit Report
  - Internal Audit Issues Tracking
- Retrospective Review Processes
- Quality Assurance and Improvement Program

Guidance for Independent Public Accountants

- Revisions to Banking Rules & Regulations
  - incorporates July 2009 changes to Section 36 of the FDI Act
  - External auditor prohibited from performing internal audit work for audit clients (SOX, Section 201)

Examination Guidance

- Determining Overall Effectiveness of Internal Audit
  - Coverage is effective or ineffective
  - Overall processes may be effective with some comments
- Relying on the Work Performed by Internal Audit
  - If audit deemed effective
  - Annual reassessment to include – adequacy and independence of audit committee; independence and quality of audit staffing; quality and scope of audit risk methodology, plan and risk assessment, adequacy of audit programs and work paper standards.
  - Reliance in individual areas may depend on scope and timing of work

Recent Accounting Developments Impacting Financial Institutions

Jon Tkach, CPA
Board of Governors of the Federal Reserve
Banking Supervision & Regulation'
Accounting Policy & Disclosure Section

FASB Financial Instruments Project– Credit Impairment

Changes to Impairment of Financial Assets

- FASB has tentatively decided that impairment of all debt instruments measured either at amortized cost (AC) or FV-OCI will be based on **expected losses**:
  - Single impairment model, irrespective of the form of the instrument (i.e., applies to loans and securities)
- Under the tentative impairment model, entities would be required to recognize an allowance for credit losses equal to contractual amounts due that are not expected to be collected
- Requires consideration of past events, current conditions, and reasonable and supportable assumptions about future economic conditions and events and impact on credit losses

Changes to Impairment of Financial Assets (cont.)

- In principle, the proposed model would lead to earlier recognition of losses and potentially alleviate some of the procyclicality concerns associated with the current incurred loss model
- Represents a diversion from the IASB's tentative model; however, the two Boards may decide to align their respective models prior to finalizing them
  - Key difference is that IASB's model delays recognition of lifetime expected losses until there is evidence of significant deterioration
- Under the FASB's tentative model, all changes in expected losses would be recognized as an adjustment to the allowance with changes reported in bad debt expense

Changes to Impairment of Financial Assets (cont.)

- The model would require institutions to revise their existing allowance methodologies based on the incurred loss model and utilize more macroeconomic data to project losses
  - This may prove to be challenging for smaller institutions
- Accounting for purchased credit impaired financial assets will remain with a few key changes:
  - At initial recognition, asset recognized at remaining contractual cash flows with an accompanying allowance for entity's estimate of credit losses and discount/premium for all other factors (sum to reconcile to transaction price)
  - Like today, discount related to credit quality not recognized as interest income
  - Subsequently, changes in cash flows related to collectability recognized as adjustment to allowance and bad debt expense

Changes to Impairment of Financial Assets (cont.)

- Fair value of collateral can be used to measure impairment for collateral dependent loans
- Practical expedient in application of model for debt instruments measured at FV-OCI if:
  - Fair value is greater than amortized cost basis, and
  - Expected credit losses are insignificant
- The concept of a troubled debt restructuring will remain
- New standard will require several new disclosures

Financial Instruments Project: Timeline

- FASB is planning to issue an exposure draft of the credit impairment standard by the end of this year
- Many expect the FASB to issue a final standard by the end of 2013; however, the effective date of the project is still in question

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